IRS Market Segment Specialization Program Paper

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MARKET SEGMENT SPECIALIZATION PROGRAM

ATTORNEYS

Department of the Treasury
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MISSION

The purpose of the IRS is to collect the proper amount of tax revenues at the least cost to the public, and in a manner that warrants the highest degree of public confidence in our integrity, efficiency and fairness. To achieve that purpose, we will:

Encourage and achieve the highest possible degree of voluntary compliance in accordance with the tax law and regulations;

Advise the public of their rights and responsibilities;

Determine the extent of compliance and the causes of noncompliance;

Do all things needed for the proper administration and enforcement of the tax laws;

Continually search for and implement new, more efficient and effective ways of accomplishing our Mission.

MISSION OF EXAMINATION

Examination supports the mission of the Service by maintaining an enforcement presence and encouraging the correct reporting by taxpayers of income, estate, gift, employment, and certain

excise taxes in order to instill the highest degree of public confidence in the tax system's integrity, fairness, and efficiency. To accomplish these goals, Examination will:

Measure the degree of voluntary compliance as reflected on filed returns;

Reduce noncompliance by identifying and cost-effectively allocating resources to those returns most in need of examination and taxpayer contact;

Conduct, on a timely basis, quality examinations of tax returns and quality contacts to determine the correct tax liability.

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CHAPTER 1

INTRODUCTION
BACKGROUND OF THE PROJECT

In 1988, a Collection group in San Diego started a project to identify attorneys who had not filed Federal income tax returns. The primary goal of the project was to enhance tax compliance among professionals who had failed to properly comply. A test was conducted which indicated that the percentage of practicing attorneys who failed to file income tax returns was greater than the average percentage of nonfilers in the general population of income tax return filers.

The results of that project led to the initiation of the Examination Division Attorney Project which was conducted under the aegis of the Market Segment Specialization Program. The purpose of the examination effort was three-fold:

1. To determine if there was a similar compliance problem with respect to items reported or not reported on filed returns;

2. To increase voluntary compliance in an area in which compliance was poor; and

3. To create a Market Segment Specialization Guide suitable for use by other examiners which would foster more efficient audits of attorneys.

SOURCES OF RETURNS

As with any project, the initial problem concerned identifying the non-compliant population. Initially, returns were secured primarily from either an IDRS listing or from returns in progress in other groups. As the project progressed, many examinations "spun-off" into examinations of related entities and other taxpayers. Audits were generally started from one of five sources discussed under "Identification of Returns."

An attorney directory was used to locate a listing of practicing attorneys in the geographic area. The attorney directory is a "Yellow Page" directory of attorneys for a geographic area, available from the California State Bar Association. Directories are published by various other sources as well. Some county and state bar associations may publish them, and private companies also publish directories which are available for a fee.

Additionally, a national directory of attorneys, called the Martingale Hubbel Directory, is available at law libraries and many large public libraries. It provides:

-- date of birth
-- educational background
-- year admitted to the bar
-- professional companies, corporations or associations
-- areas of expertise
-- current law firms
-- rating of expertise (recommendations from other lawyers and judges).

Martindale Hubbel directories are available for major metropolitan areas of California, and presumably for other states as well. Be aware that these directories may not be all inclusive. Many small firms and sole practitioners are not listed. Therefore, the Martindale Hubbel Directory should not be relied on exclusively as a means of securing returns.

For the purposes of this study, the San Diego County Attorney Directory was used. Although listing in the directory is voluntary, many attorneys use this as a form of advertising and cross-referencing to specialists in other areas of law. The San Diego directory provides an alphabetical list of attorneys practicing in the area, as well as the college and year of their graduation.

A random sample consisting of hundreds of names was secured from the San Diego directory, and Employer Identification Number/Social Security Number (EIN/SSN) information was secured utilizing the IDRS. Transcripts were secured based on the EIN/SSN information, and a determination was made as to filing history. Transcripts for a 5-year period were used to

ensure that as complete a filing history as possible was seen. Based on TC 150 postings, the transcripts were used to identify those practicing attorneys who potentially had not, in the past 5 years, filed Federal income tax returns or who had filed returns but failed to report all income.

IDENTIFICATION OF RETURNS

BMF Filed Returns

One potential source of examinations was returns filed with the Fresno Service Center. A request was made of the local Computer Audit Specialists for a sorting of those BMF returns filed which showed an industry code indicating legal services (industry code 8111). High activity code returns were found generally to be those of relatively large, well-established firms. It was found that sole proprietorships utilized a different industry code (7617) and that a sort on this code was not possible, since the data was not entered when the returns were initially processed by Fresno Service Center. Based on the results of the San Diego audits, it was more productive, from both a yield and compliance standpoint, to concentrate on smaller firms. Internal controls tended to be much more stringent in large corporations than in sole proprietorships or a closely held corporations.

For tax years 1990 and later, information may be secured from the Individual Return Transaction File (IRTF) utilizing command code RTVUE on the IDRS. Available data includes certain Schedule C line item entries. This information may be used to select returns which appear to have audit potential prior to the actual receipt of a tax return. The command code BRTVU can be used to secure information for corporate and partnership filing for tax years 1990 forward.

In-Service Referrals

As a part of Collection Division's effort, revenue officers secured transcripts and determined whether the returns had been filed. Those whose transcripts showed a filing history were batched and sent to a Field Examination group for inspection. Transcripts were examined to determine the pattern and source of income over the past 5 years. Potential candidates for examination were also received from Criminal Investigation Division (CID), Examination Compliance groups, and Office Audit groups. Particular attention was given to levels of income reported, source of that income (whether from self- employment or Forms W-2), amounts and sources of self-employment or Forms W-2, amounts and sources of withholding credits, total tax paid, and the nature and time of prepayment credits. This data was analyzed in conjunction with the year and school of graduation. Analyzing the data in this manner was helpful in identifying new attorneys with a propensity to earn substantial income because of graduation from a prestigious law school. Based on an analysis of all the available information, a preliminary decision could be made whether to secure the returns for inspection.

Nonfiler Fraud Referrals

A small number of those taxpayers who had initially exhibited no known filing history were developed as potential fraud referrals. An asset search was conducted to determine the scope and nature of the taxpayer's asset acquisitions over the past 5-year period. Refer to the section on pre-audit analysis for detailed asset search information. A checksheet was developed to ensure that all relevant material was included in the determination, and to ensure uniformity of selection (see Exhibit 1-1). Those individuals who had no known assets, or whose asset acquisitions were of relatively minimal nature, were set aside. Those who had acquired significant assets were selected for examination.

Self-Generated Work

As the project progressed, it became clear that the examinations could not reasonably be restricted to the taxpayer under examination. Many taxpayers had control over other related entities which also were required to be audited. Additionally, the relationships between the taxpayer under examination and other individuals with whom he or she had financial dealings became important. For example, an attorney may have professional dealings with other attorneys, CPA's, and other individuals who may or may not be clients.

Out-Service Referrals

Many other sources of information were utilized to gain information on prospective leads. These included the national attorney directory, the yellow pages, newspaper articles, and TV and radio advertisements. In many cities, newspapers belong to a database search system such as NEXUS or Data Times. These systems may be queried either under a specific name, or under a more generic topic. One easily accessible and informative source was a periodical called "California Lawyer." This magazine routinely publishes disciplinary notices from the California State Bar Association. In certain cases, it was shown that the disciplinary notices issued to a particular attorney also had tax implications. The notices were public information because they were part of the court records, and, therefore, in the public domain. Information regarding ongoing disciplinary investigations may he obtained from investigators with the State Bar Association.

Conclusions

Information which resulted in the selection of returns and/or taxpayers within the attorney market segment was secured from a variety of sources. As the project progressed, it was determined that the internal sources, such as the DIF system, typically yielded results which were inferior to returns from other sources. Of the five sources of returns, it was generally shown that referrals, both in-Service and out-Service, and self-generated work provided the best leads. Once a productive lead was established, it was seen that the audits had a tendency to "splinter." That is, examinations of targeted individuals resulted in collateral examinations of related entities and related taxpayers.

EXHIBIT 1-1

TAXPAYER'S NAME: AGENT:
FORM: YEAR:

NON-FILER CHECKSHEET

1. Order transcripts (Form 6882) Date_____

2. Order IRP (Form 6632) Date_____

3. Order TECS Date_____

If you have difficulty locating taxpayer, try:

a. Real Estate Microfiche (Library) Date_____

b. Utilities (take commission & go to Security Office) Date_____

c. Employment Development Department (Form DE 8720) Date_____

d. Social Security Administration (Form 2264) Date_____

e. DMV (Call Interagency Compliance Coord 8-896-4825) Date_____

f. CA Dept of Corp 8-916-445-2900 (status of corp)
8-916-322-2287 (names & addr-offcrs)
Partnerships 8-916-324-6769 (names & addr-ptnrs)
Date_____

4. Decide whether the case has fraud potential. Factors to consider:

a. Number of years of nonfiling

b. Amount of deficiency

c. Amount of withholding

d. See LEM IV

If you decide the case has fraud potential, follow fraud nonfiler procedures. DO NOT SOLICIT A RETURN! If the taxpayer is self-employed, you may not be able to make this decision until you have seen the taxpayer and the records.

5. Establish "Substitute for Return." CAUTION: Be sure you have enough or feel you can get enough information to prepare a Report if you cannot locate taxpayers or they prove to be uncooperative. Date_____

6. Contact the taxpayer by telephone first. Then mail FL-2002 (if you have decided against fraud) or general contact letter (if undecided about fraud potential). Date_____

7. Penalties include:

(for returns due before 12/31/89) (for returns due after 12/31/89)
Section 6653 Negligence Section 6662(c)

Section 6651 Delinquency/Failure to Pay Section 6651
Section 6654 Estimated Tax Section 6654
Section 6661 Substantial Understatement Section 6662(d)(1)(A)
Section 6653 Fraud Section 6663(a)

CHAPTER 2
OVERVIEW OF ATTORNEY RETURNS
GENERAL INFORMATION

There are approximately 9,000 practicing attorneys in San Diego County. Many are engaged as employees, but a large number are self-employed, partners, or shareholders. The businesses with one person having the majority of internal control have the most audit potential. It was found that attorney-employees of large firms had substantially less opportunity to manipulate the books than the sole proprietor or shareholder. Inspection of some returns disclosed obvious areas of adjustment not in line with the assigned DIF scores. Therefore, the assigned DIF score should not be taken as the only indicator of adjustment potential. Those returns that look very clean on the surface can yield high adjustments if there are funds bypassing the general account. It is very helpful to obtain transcripts for at least three years to ascertain any unusual changes in income and taxes paid before initiating an examination.

Certain areas of attorney specialization are more productive than others. The personal injury area produces adjustments through the advanced client costs adjustment (see later discussion), since, by nature of the specialty, significant client costs may be advanced prior to settlement. Criminal attorneys have more access to cash receipts than most other attorneys. Here CTR's are most helpful in determining the existence of cash receipts from clients. Real estate attorneys may receive an ownership interest or a second trust deed for services rendered. Immigration attorneys are also in a position to receive cash for services.

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.

RECORDKEEPING

The essential features of an accounting system for attorneys provide for control of fees billed as well as for costs and expenses advanced for clients. Time is the basis for establishing fees unless the attorney works on a contingency basis. For that reason an attorney will maintain a record to track the exact time spent on any given case.

This information is recorded on a client ledger card along with all expenses chargeable to the client. All attorneys maintain this information in one form or another. If an actual ledger card is not kept, a client file will exist which contains charges and costs.

Upon receipt of income, 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 and client costs paid. The records for one-attorney businesses may consist of the bank statements and checks; however, the client ledgers or files will exist in one form or another.

IRM 4231-6(14)4.2 (See Exhibit 2-1 at the end of this chapter) lists the following as records which may be found in an attorney's office:

1. Appointment book;

2. Clients card index;

3. Daily log or receipts book;

4. Disbursements book or ledger, showing breakdown of regular expenses paid, as well as disbursements made from trust funds;

5. Individual client's accounts showing description of service, charges and credits;

6. Case time record per client;

7. Register of cases in progress, by client's name;

8. Time report per attorney and per client, showing time, dates of work, and billings or charges.

Charles H. Zwicker, CPA has written an excellent article outlining the general features of law firms and the accounting systems that should be maintained (see Exhibit 2-2). Remember that, regardless of specialty, the basic records maintained by the attorney are similar.

BANK ACCOUNTS

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 the accounts should be handled.

Trust accounts should be used for all funds received or held by an attorney for the benefit of clients. The attorney is the trustee of the account and has the power to disburse funds on the client's behalf. In California, the administration of trust accounts is determined by statute under the Business and Professions Code. There are also guidelines under the Rules of Professional Conduct of the State Bar Association.

Trust funds are 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 labelled "Trust Account," "Attorney/Client Trust Account," "Client's Funds Account," or some similar title. The earnings on trust funds must either be paid to the State Bar Association or to the client. Therefore, the bank accounts show either the identification number of the Bar Association or the client.

The client cannot compel the attorney to invest funds on the client's behalf. In cases where the client funds are either of more than a nominal amount or are to be held for a long period of time, the funds must be deposited into an account the interest on which is payable to the client. Whether the funds are placed in a general trust account or into a separate trust account for the benefit of one client is determined by the attorney. These two types of trust accounts are explained below:

1. GENERAL TRUST ACCOUNT

This account includes trust funds received on behalf of many clients and may be the only trust account maintained by an attorney. According to the Business and Professions Code,

"Funds that are nominal in amount or are on deposit for a short period of time are to be placed in an unsegregated account on which the interest is paid to the State Bar."

Interest on this account is remitted directly by the bank or other financial institution directly to the State Bar. The Bar distributes the interest income to programs that provide free legal services to the poor. Automatic debits appear on the bank statements for the interest which is being paid to the Bar. This is generally done monthly, but must be done at least quarterly. 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 this 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.

2. SEGREGATED TRUST ACCOUNT

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. The State Bar advises that a separate account should not be set up unless at least $ 50 will be earned by the account.

This type of account may be used for the proceeds of property sold in a divorce or an estate. The amount could be significant, and the funds may not be distributed immediately. The interest should then go to the client rather than to the State Bar.

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. The 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.

Interest earned on the pooled trust account funds and paid over to the State Bar is not taxable to the clients, the attorney, or the State Bar. 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).* Refer to the section on gross income for detailed discussion of related deferral of income issue.

The attorney should be able to provide an accounting of any amounts in the trust accounts. The Rules of Professional Conduct state that the attorney must:

> Maintain complete records of all funds, securities, and other properties of a client coming into the possession of the member or law firm and render appropriate accounts to the client regarding them; preserve such records for a period of no less than five years after final appropriate distribution of such funds or properties; and comply with any order for an audit of such records issued pursuant to the Rules of Procedure of the State Bar.

Each state's Bar Association may imposes different criteria for conducting an examination. 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 their state Bar Association to determine local policies.

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, it behooves the auditor to carefully examine deposits into all bank accounts, as well as to account for personal living expenses and cash expenditures. Care should be taken to identify loans and other nontaxable sources of income during the initial interview.

ATTORNEY-CLIENT PRIVILEGE

Attorneys may refuse to provide any documents which contain client's name. This can include a client list, general ledger, client ledger cards, cancelled checks, and client trust accounts.

All court cases in this section are categorized and cited in Exhibit 2-3.

History

The attorney-client privilege was first delineated in *United States v. United States Shoe Mach. Corp., 89 F. Supp. 357, 358-59 (D. Mass. 1950).* The historical basis of the privilege and how the attorney-client privilege applies is well laid out in *Colton v. United States, 306 F.2d 633* (2d Cir, 1962).

> 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.
>
> Also found in Colton are the four basic elements of the privilege:
>
> Generally it may be said that the attorney-client privilege applies only if:
>
> (1) the asserted holder of the privilege is or sought to become a client;
>
> (2) the person to whom the communication was made

(a) is a member of the bar of a court, or his subordinate and

(b) in connection with this communication is acting as a lawyer;

(3) the communication relates to a fact of which the attorney was informed

(a) by his client

(b) without the presence of strangers

(c) for the purpose of securing primarily either

(i) an opinion of law or

(ii) legal services or

(iii) assistance in some legal proceeding, and not

(d) for the purpose of committing a crime or tort; and

(4) the privilege has been

(a) claimed, and

(b) not waived by the client.

Fee Arrangements and Client Identity

In *Baird v. Koerner, 279 F.2d 623 (9th Cir. 1960),* the Court first held an exception to the general rule that fee arrangements are not within the attorney-client privilege. In *Osterhoudt v. United States, 722 F.2d 591 (9th Cir. 1983),* the Court stated that the purpose of the attorney-client privilege is to protect every person's right to confide in counsel from the apprehension of disclosure of confidential communciations. Fee arrangements usually fall outside the scope of the privilege simply because such information ordinarily reveals no confidential professional communication between attorney and client.

In *United States v. Hodge and Zweig, 548 F.2d 1347 (9th Cir. 1977),* the court stated:

* * * 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 fee arrangements with his clients are not confidential communications protected by the attorney-client

privilege.

In that case the IRS demonstrated that the information at issue was sought for a legitimate purpose -- the collection of tax revenues -- and, therefore, the information was not privileged.

In Osterhoudt, the Ninth Circuit limited the Baird exception to its facts. In the same case, the Court noted Baird and Hodge & Zweig, and explained the Baird exception as follows:

> The name of the client will be considered privileged matter where the circumstances of the case are such that the name of the client is material only for the purpose of showing an ACKNOWLEDGMENT of guilt on the part of such client of the various offenses on account of which the attorney was employed.

Osterhoudt at 593.

Implying that Baird was fact specific, the Ninth Circuit stated:

> 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 * * *.

Osterhoudt at 593.

Thus, the general rule is that disclosure of client identity is not an infringement of the attorney-client privilege. 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 and the name be held as privileged. 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).*

Summonses

When the taxpayer/attorney still refuses to submit documents based on attorney-client privilege, it may be necessary to issue a summons.

In Reisman v. Caplin, the Supreme Court held that an Internal Revenue summons may be challenged on the grounds of attorney-client privilege. However, the burden is on the taxpayer to

prove that the information requested falls within the attorney-client privilege, United States v. Johnson.

In U.S. et al. v. Hartigan, the primary issue raised in the proceeding to enforce an Internal Revenue summons issued pursuant to Title 26 *Section 7602,* was whether a lawyer's fee ledger is privileged information:

> Attorney-client privilege: Lawyer's fee ledger. -- A 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.

In Donaldson, "* * * Congress clearly has authorized the use of summonses in investigating what may prove to be criminal conduct." The Court went on to hold that:

> * * * under *section 7602* an Internal Revenue summons may be issued in aid to an investigation if it is issued in good faith and prior to a recommendation for criminal prosecution.

Consistently the courts have held that generally a lawyer's own record of fees collected from a particular known client does not fit within the definition of confidential communications. In Colton, in an appeal of an order denying a motion to quash a summons directed to the taxpayers' tax counsel, the court decided that the lawyers must answer questions concerning remuneration received from the clients during the time period under investigation. The court stated that:

> * * * 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. All matters are quite separate and apart from the substance of anything that the client may have revealed to the attorney.

In accord is United States v. Hodgson, where the court held that the attorney-client privilege does not prevent the IRS from requiring a lawyer to produce records of all charges and fees received from a client under investigation by the IRS.

In Hartigan, it was determined:

> * * * Because the summons is an aid of an investigation of a tax liability and because a client fee ledger is not protected by the attorney-client privilege, and because the summons was prepared in good faith in the investigation of a tax liability, Mr. Hartigan's motions to quash the summons and for an

evidentiary hearing was denied.

The attorney-client privilege does not cover a law firm's client-trust fund bank account, and a summons to the bank will be enforced. See United States v. Union First National Bank of Washington.

A narrow exception to the general rule that the identity of the client and the amount of the fee paid is not within the attorney- client privilege exists. 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 relationship or possible litigation strategy is generally protected. Similarly, other documents which reveal the nature of the services provided should also fall within the privilege.

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 n.6 (D.P.R. 1991).* This, a simple invoice requesting payment which reveals nothing more than the amount of the fee would not normally be privileged.

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 section 7602(c)*. 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.*

The Service's summons power is not absolute, however. It is limited by traditional privileges, including the attorney-client privilege. *Upjohn Co. v. United States, 449 U.S. 383, 398 (1981).* The burden of proving the privilege falls upon the person claiming it. The attorney may not assert the privilege for his own benefit. *United States v. Abrahams, 905 F.2d 1276, 1283 (9th Cir. 1990).*

Information Reports

In the recent case of United States v. Goldberger & Dublin, P.C. regarding *I.R.C. Sec. 6050I* and Form 8300 reporting requirements, the Second Circuit Court of Appeals affirmed an unreported District Court decision. The District Court required attorneys and their firms to provide the Internal Revenue Service with names of clients who paid them cash fees in excess of $ 10,000. The District Court held that respondents must comply with the IRS summonses and provide the payor information. Additionally, the Eleventh Circuit in *United States v. Leventhal, 961 F.2d 936 (11th Cir. 1992)* similarly held that an attorney who had filed two Forms 8300 which failed to disclose the payors' names, addresses, social security numbers, and descriptions of the transactions, had to comply with a summons requesting such information. Further, before the Eleventh Circuit's decision in Leventhal, the District Court for the Northern District of Georgia applied the Goldberger rationale to similar facts in *United States v. Garland, 92-1 U.S.T.C. para. 50, 218 (N.D. GA. 1992).*

The Eleventh Circuit has taken the same approach. *United States v. Leventhal, 961 F.2d 936, 940 (11th Cir. 1992).* 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.* Accordingly, a claim of attorney-client privilege precluding disclosure of information on a Form 8300 must be the exception rather than the rule.

Finally, attorneys who, because of state ehtical rules, withhold the names of clients or fee arrangements, will not be considered to have shown special circumstances bringing them within the attorney- client privilege. In summons enforcement actions, which involve violations of Federal law, it is the Federal common law of privilege that applies. *Goldberger, 935 F.2d at 505.* State ethical rules must yield to conflicting federal law.

Nevertheless, many state ethical rules extend protection greater than that afforded by the attorney-client privilege and address only the interests of clients. They do not take into account the important counteracting interest that the Government has in obtaining nonprivileged information required to be produced by law. "The fact that a federal statutory scheme is at odds with model disciplinary rules or state disciplinary codes hardly renders the federal statute invalid." *Caplin & Drysdale, Chartered v. United States, 491 U.S. 617, 633 n.10 (1989).* Moreover, it is the responsibility and ethical duty of attorneys to educate clients on the requirements of the law, not to encourage wrongful disclosure.

Since the focus of this paper concerns Title 26 examinations of the attorneys themselves, further questions concerning the National Office litigation project regarding Form 8300 reporting should be routed through the District's Technical Coordinator.

SUMMARY

When an attorney attempts to hinder the audit by claiming attorney-client privilege, we can give him or her a list of the court cases and state the following facts:

1. Generally the privilege must be claimed by the client and the right must not have been previously waived. Any disclosure of would privileged communication to a third party or consent of disclosure result in waiver of the right. 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. However, the attorney may not claim the privilege for his or her own benefit. See *United States v. Abrahams, 905 F.2d 1276 (9th Cir. 1990),* in which the Ninth Circuit rejected an attorney's claim of privilege in a summons enforcement proceedings as to the names and fee arrangements of clients.
2. The privilege protects the disclosure of confidential communications between client and attorney.
3. 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.

4. A summons prepared by the IRS in good faith will be enforced.

5. The burden is on the claimant to prove attorney-client privilege.

EXHIBIT 2-1

6(14)2.46 (4-23-81) 4231

Depreciation

The year and manner of the acquisition of assets should be checked, noting the financial arrangements and whether the funds used came from a properly identified source.

6(14)2.47 (4-23-81) 4231

Repairs

The cancelled checks should be examined in conjunction with the invoice to determine the nature of the expenditure as well as to verify the actual cost.

6(14)2.48 (4-23-81) 4231

Insurance

Obtain a breakdown of payment and verify that personal items such as life, health, and auto insurance have not been deducted.

6(14)2.49 (4-23-81) 4231

Travel and Entertainment

(1) The examiner should pay particular attention to amounts claimed for entertainment and similar expense.

(2) Travel expenses paid in connection with attending a medical convention are generally deductible, (but not the family portion).

(3) The entertainment of other doctors and patients which is of a reciprocal nature should not be allowed. An example of this would be a group of doctors who customarily refer patients to one another and who also attend social events together for which they take turns purchasing the tickets. Another example would be the reciprocal cost of meals by doctors who are associated with the same hospital or who

share a medical suite and lunch together.

6(14)2.5 (4-23-81) 4231

Automobile

Examiner should ascertain that the expenses for commuting between a doctor's residence and the office were not claimed. The examiner should apportion auto expense as to business and personal. The facts in each case should govern.

6(14)2.6 (4-23-81) 4231

Education

(1) The cost of refresher courses may be allowed only to the extent they are necessary to keep doctors advised as to new developments in their field. The cost of instruction in a field in which they have not previously engaged is not allowable. Prolonged courses may indicate new skills were being acquired.

(2) Psychoanalysis and psychiatrists frequently incur expenses for personal analyses which may be required in their profession. Such expenses usually arise near the close of their training or just prior to the start of their practice. Such expenditures are not deductible as medical or business expenses.

6(14)2.7 (4-23-81) 4231

Physician and Patient -- Privileged Communications

The Federal courts have assumed the communications made by a patient to a physician, while seeking professional advice, are privileged. This privilege has not been extended to financial matters, such as the amount of fees paid for professional services.

6(14)3 (4-23-81) 4231

Dentists

(1) The accounting system and records of dentists are very similar to that of other doctors. A dentist usually keeps an appointment and daily log book designed especially for dentists.

(2) In contrast to the examination of other doctors, the costs of supplies in a dentist's work will be higher, due to the use of gold, silver, etc.

(3) In determining correct income, the examiner should verify

that the sale of used precious metals has been included in gross income.

(4) The procedures for verification of income of a doctor should be followed in the examination of a dentist's tax return.

6(14)4 (4-23-81) 4231

Attorneys

6(14)4.1 (4-23-81) 4231

Privileged Communications

(1) The important issue of "privileged communications" between an attorney and clients, as related to an examination of the attorney's return must be understood by the examiner. This is particularly so if the examiner is to secure pertinent financial information when dealing with an attorney.

(2) The mere relationship of attorney and client does not render confidential every communication made by the client to the attorney. If the attorney is just a conduit for handling funds, or the transaction involves a simple transfer of title to real estate, and there is no consultation for legal advice, communications made by the client are not privileged.

(3) Communications made in the course of seeking business advice rather than legal advice are likewise not privileged.

(4) It has been held that the privilege is inapplicable to communications made to a person who is both an attorney and accountant, if they have been made solely to enable him to audit the client's books, prepare a Federal income tax return, or otherwise act solely as an accountant.

(5) Examiners should be able to secure from attorneys any records or information in their possession, except those containing the privileged communications, which will aid in the examination of personal returns.

6(14)4.2 (4-23-81) 4231

Records

(1) The accounting and financial records of an attorney will vary, according to the business arrangements of those involved. In a partnership, or office where there is an associate arrangement, there will usually be complete and adequate records, consisting of all or

some of the following:

(a) appointment book;

(b) client's card index;

(c) a daily log or receipts book;

(d) a disbursement book or ledger, showing breakdown of regular expenses paid, as well as disbursements made from trust funds;

(e) individual client's accounts showing description of service, charges and credits;

(f) case time record per client;

(g) register of cases in progress, by client's name; and

(h) time report per attorney and per client, showing time, dates of work, and billings or charges.

(2) The records that may be found in the office of a single attorney are:

(a) an appointment book;

(b) diary or day book;

(c) a recording of fees received (many times this is kept by the attorney personally);

(d) a running account of expenses paid;

(e) costs relating to a case which may be maintained on the inside page of the folder containing the case file;

(f) single entry disbursement book, ledger or sheet;

(g) monthly recapitulation schedule of fees and expenses; and/or

(h) duplicate deposit slips, bank statements and canceled checks.

(1) An accounting feature, peculiar to practicing attorneys, is the trust fund or escrow account. Some States prescribe responsibility for the accounting of client's funds, or funds held in suspense by the attorney.

(2) Usually the attorney will deposit into this account funds received from the client which will be subject to disbursement for various reasons. Some will apply to the attorney's fee, some will be disbursed to other attorneys and/or other parties to a suit or business transactions, and some to expenses. Good practice dictates that attorneys clearly identify funds withdrawn, and record them in another part of their records, but this is not always done.

(3) The examiner should be alert to determine that the attorney has disclosed all special accounts, all accounts with associates, all trust fund accounts (since there may be more than one), and all partnership accounts.

6(14)4.4 (4-23-81) 4231

Source of Fees

(1) A practicing attorney's principal source of income is from fees received for representing clients in any number of situations.

(2) Types of fee arrangement include single retainer fees, annual retainer fees, contingent fees, and referral fees. The single retainer fee may be received in advance, in full or in part. The annual retainer fee may be received monthly or at other intervals. Contingent fees are based upon a percentage of amounts collected or recovered. Referral fees are received from other attorneys to whom clients are referred for services.

6(14)4.5 (4-23-81) 4231

Expenses

(1) The expenses of attorneys, such as rent, utilities and automobile, are similar to those of other professional persons. In addition to the ordinary expenses of the profession, an attorney has expenses on behalf of clients. Generally, advances in cash for expenses incurred by an attorney on behalf of a client are not deductible where the attorney is entitled to reimbursement and in fact is to be reimbursed. The usual practice in regard to a client's cost on a case is to charge for the costs and deduct them from the settlement received. In personal injury claim cases taken on a contingent fee basis, the attorney may not be entitled to reimbursement; therefore, the expense would be deductible in the year expended. If claimed as current expenses, the examiner should

determine that the proper amount is included in income when settlement is received. If these expenditures are made through the trust fund, an analysis of that account will reveal whether the disbursements were properly recorded.

(2) Many attorneys contribute to election campaign funds of State, county, and local officials. Examiners should satisfy themselves that these contributions have not been claimed as business expenses by the attorney.

Engineers

(1) Engineers are usually subject to registration in the various States in order to operate on a professional basis. The work of the engineer is divided into several highly specialized fields and includes designing, estimating, supervising construction, consulting and related activities.

(2) The income of professional engineers consists of fees which are usually received in accordance with the terms of a contract. A written contract should exist between the engineer and the principal for each job undertaken. The contract should include a description of the services to be rendered, an estimate of the time required to perform the work, and the terms for the settlement of the fee.

(3) Fees may be received upon the completion of work or when it is delivered and accepted, or progressively as the work is completed. It is not unusual to find that the engineering services on long-term contracts are paid for in accordance with the percentage of completion of the job, or in installments over the period of the project.

(4) The contracts should be available for the verification of income, and the specific job costs can usually be related directly to the income items. Estimates of the percentage of completion of the jobs in progress at the end of the period are usually available for the verification of reportable income.

Architects

(1) The profession of the architect is in some respects similar to that of the engineer. The architect is employed to design buildings and to supervise their construction to see that it conforms to specifications. Income is derived from fees.

(2) The compensation of the architect is sometimes a fixed percentage of costs of construction. It is also based on direct labor costs plus an allowance for overhead, fees for

consultants, etc. The compensation is usually paid in installments, the first payment being made when the contract is signed. Other installments may be received as the work progresses, with full settlement when the completed structure is accepted.

(3) There are occasions when architects are issued stocks or securities in the corporation for which they have performed services. The examiner should be aware of the possibility that this type of transaction has been negotiated.

(4) When contractors bid on the construction designed by the architect they are usually required to deposit performance guarantees with the architect as security for the building plans and specifications used in making their estimates. The deposits are returnable to the contractor when the performance is completed. Until such time, the architect reports the deposit as a liability. The return of the deposit is not an expense.

(5) The architect may be called upon to make advances on behalf of the client, such as for the purchase of certain equipment which the client is obligated to furnish. This type of transaction is an account receivable until satisfied. It should not be charged as an expense.

(6) A large item of expenditure by architects is for blue prints and supplies. The costs of blue prints are usually charged to the cost of specific jobs.

(7) Usually contracts are signed with clients for the specific jobs, wherein the basis of compensation is defined. The examiner should examine these contracts in connection with the verification of the fees recorded.

EXHIBIT 2-2

Lawyers

by
CHARLES H. ZWICKER, CPA

Professor of Accounting
Dean, School of Professional Accountancy
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THE PROFESSION IN BRIEF

Entry into the profession and the right to practice as an attorney are entirely contingent on meeting state and federal requirements for admission to the Bar. These differ from state to state, and the federal and specialized courts have their own requirements.

Basically, a law degree from an accredited law school is required in order to sit for the state Bar examinations. On passing the examination and satisfying the committee on character and fitness, the applicant is licensed to practice law. This he may do as a sole practitioner, as a member of a partnership, or as a member of a professional corporation. The decision as to which type of entity to adopt is usually dependent on the size of the firm and the number of principals.

Admission to the state Bar does not automatically license an attorney to practice before the federal courts. Practice before the United States Supreme Court requires at least three years experience before the highest court in his own state and the personal recommendation in open court by a member of the Federal Bar. Each federal or circuit court dictates its own requirements, as do special courts as the United States Tax Court and the United States Court of Claims.

General Features

Law firms may vary in size from the individual practitioner with one employee-secretary to the large Wall Street law firm with a multitude of partners and hundreds of employees such as attorneys, clerks, secretaries, typists, bookkeepers, librarians and the like. In addition, firms may differ as to the kind of work they do. There is the general law practice which will handle everything from personal injury cases to corporate reorganizations. Others may engage in specialties alone, such as corporation law, admiralty law, patents, criminal cases, estates, etc. Generally, however, even specialists diversify to some degree. Many lawyers and their firms enter into activities on the periphery of the profession and deal in real estate and handle financial negotiations for clients with banks and underwriters.

Accounting Problems

Law firms, regardless of their form of operation, usually use the cash receipts and disbursements method of income determination for tax purposes, and the calendar year as the fiscal period. For purposes of internal control and evaluation of operations, and determination of the fee structure, the accrual method is used.

Since time is the lawyer's stock in trade, each lawyer maintains a carefully detailed diary listing time expended on each matter. With costs of operations ever on the rise, records should be kept of productive and unapplied time, as well as fixed expenses such as rent, telephone, stationery and other disbursements directly applicable to specific cases.

From the details of proper accounting, cost per hour may be determined by dividing the overhead expenses by the number of working hours. This would be the basis for determining fees and the establishment of projected desired income. In any event, it is desirable and good business procedure to know what the cost per hour is and the ratio of productive to non-productive time.

Financing Problems

Capital usually is not a significant factor in establishing and maintaining a law office, although there may be considerable investment in library, desks, typewriters, and working funds. This would be dependent on the type of practice and the method of billing and collecting from clients.

While time is the basic ingredient in setting fees, there are different arrangements which are employed.

1. Specific retainer. This is an agreed fee for a particular case, part of which may be payable in advance.
2. Annual retainer. This is again an agreed fixed fee but for complete legal services for a specified period of time, generally a year. However, provision is made for supplementary fees for special or unusual services which may be required.
3. Contingent fee. This is an arrangement involving a certain agreed percentage of the proceeds of a successful settlement of a legal matter.
4. Forwarding fee. Where cases are referred to other

attorneys, a percentage of the ultimate fee paid is remitted to

the lawyer originating the case.

Where a contingent fee is involved, lawyers may make expenditures on behalf of the client in regard to expenses directly related to the case. Careful records of these must be maintained and especially so for trust and escrow funds received which are held for the client. Examples are sums received in escrow from the satisfaction of judgments, from deposits and proceeds arising from real estate transactions, and the liquidation of estates. There should be no commingling of funds with the regular bank account.

Tax Problems

For tax purposes, the cash basis of income reporting is generally followed, and the form of tax return is dependent on the types of organization adopted -- i.e., individual, partnership, or professional corporation. The cash basis is considered preferable since its use involves a tax only on realized income, and eliminates from taxable income such items as uncollected receivables.

The adoption of the professional corporation type of operation brings with it certain problems such as reasonableness of shareholder-employee salaries, the possibility of double taxation, a penalty tax on undistributed profits, and the usual complexities of the corporate structure.

Basically, however, the tax problems of the lawyer or law firm do not differ from those of other professions or business firms.

Asset Peculiarities

Equipment in a law office is dependent almost entirely on the size of the firm. It may range from two desks, a typewriter, and a file cabinet to a complex involving a terminal leading to a million dollar computer. Every firm, however, creates a library which is essential to the conduct of its practice. This again varies in size and may include a wide selection of books of index, encyclopedias, citators, loose-leaf services, textbooks, and tables of cases. Dependent on the type of practice, there are specialized services such as Prentice-Hall Federal Tax Library. In well-run firms, the library represents a substantial continuing investment.

Reference books having permanent value are reflected in operating expenses by a charge to depreciation. The cost of subscriptions and renewable services is written off annually.

Ownership Peculiarities

Most law firms are operated as sole proprietorships and partnerships, and capital accounts and drawing accounts are established for each principal. Profits and drawings are determined in accordance with the partnership agreement, in the case of a partnership, and the balance not drawn represents the ownership interest in the net capital.

In the case of the professional corporation, the terms of the certificate of incorporation and the by laws prevail. A capital stock account is set up, with a stockholders ledger listing each shareholder.

THE ACCOUNTING SYSTEM

The basic purpose of any good accounting system is to accumulate and summarize the income and expense in such a way as to obtain financial information to:

a. determine the profitability of the operation

b. control costs

c. set fees

d. provide a basis for planning

e. provide information for the tax returns which must be prepared.

The complexity of the accounting system is dependent on the size of the firm and the purposes to be accomplished.

Control of Expenditures

Sources of billable disbursements and advances are the Cash Disbursements journal and the Petty Cash journal. These, together with the Time and Expense Reports, provide the information for entry in the Client's Ledger and interim or final billing to the client.

Cash Disbursements Journal

Most expenditures are made by check and the cash disbursements journal records each check issued, with provision for indication which client and which expense is to be charged for that particular disbursement. A separate column is provided for billable items, under the leading Accounts Receivable. These are posted directly to the Client's Ledger card. Other columns, generally a general ledger column, are provided to record overhead expenses such as rent, telephone, salaries, and other disbursements not chargeable directly to clients (see Figure 1).

FIGURE 1
CASH DISBURSEMENTS JOURNAL

Date Paid to			ACCOUNTS RECEIVABLE				
				Fee			
				Participation		General	
Bank #1	Bank #2	Client	Case #	Amount	Name	Amount	Account Amount

Petty Cash Journal

Expenditures of generally a minor amount, made in each rather than by check, are entered in the Petty Cash Journal. Some of these disbursements are charged to clients and the remainder are for miscellaneous office expenses. These should be supported by vouchers signed by the payee and approved by a principal. (See Figure 2.)

FIGURE 2
PETTY CASH JOURNAL

			Accounts Receivable		General	
Date	Payee	Amount	Client	Case #	Amount	Account	Amount

FIGURE 3
CLIENT'S OFFICE CHARGE MEMO JOURNAL

Date	Client	Case No.	Amount	Stenography	Tolls	Photocopy	Misc.

FIGURE 4
CLIENT'S LEDGER CARD

Client File No.____
Address Billing Partner_____

				Steno &		
Date	Folio	Case No.	Fees	Disbursements	Photocopy	Total

_____
_____
_____
_____
_____

FIGURE 5
ACCOUNTS RECEIVABLE-BILLED

Client File No.____
Address Billing Partner_____

_____

Date Folio Case No. Debits Credits Balance

_____
_____
_____
_____
_____
_____
_____
_____

Lawyers

Accounts Payable

Ordinarily, a purchase journal is not required. A tickler file can be established, one for unpaid bills, and the other for paid bills, with transfer from one to the other as the bills are paid.

Absorbed Costs

On occasion there may be certain expenses incurred in connection with a client which may, either for expediency or policy, not be charged to the client. These amounts would be recorded in the Absorbed Costs account and reflected in the Income Statement.

Office and Stenographic Charges

Clients are often charged for allocable office expenses on their behalf, such as stenography, toll calls, photocopy work, etc. A Client's Office Charge Memo Journal is kept to record these billable charges and posted to each Client's Ledger Card. (See Figure 4.)

In summary, billable charges to the Client's Ledger Card come from the following sources:

(1) Lawyer's Time and Expense Reports

(2) Cash Disbursements Journal (Figure 1)

(3) Petty Cash Journal (Figure 2)

(4) Client's Office Charge Memo Journal (Figure 3)

(5) Miscellaneous memoranda to reflect special situations.

Billing and Accounts Receivable

The Client's Ledger Card (Figure 4) thus contains all items chargeable to the client from the sources enumerated. At this point, it represents a work in process or Unbilled accounts receivable record.

From the contents of the card, when the case is concluded, or in the event of interim billing, an invoice is prepared in duplicate. One copy is sent to the client, and the other is retained by the accounting department, which transfers by journal entry the amount billed out of the Client's Ledger Card to the Accounts Receivable-Billed account (Figure 5). In effect, there are now two accounts receivable accounts -- one billed, and the other unbilled.

Cash Receipts Journal

Amounts received as collection of invoices rendered are deposited in the bank account, and recorded in the cash receipts journal (Figure 6). Postings to individual Accounts Receivable-Billed accounts are made from the Accounts Receivable column in the cash receipts book, and the status of the receivables is thus constantly maintained. Other items of receipts are entered in the General column, with designations as to which account is to be credited. The number of columns may be expanded to show fee participations, etc., as the need requires.

CLASSIFICATION OF ACCOUNTS AND BOOKS OF ACCOUNT

Accounts Peculiar to the Profession

Following is a list of accounts appearing in the general ledger of a law firm. This may be expanded or modified as found necessary. (See Figure 7.)

The major journals are a cash receipts book in which all receipts are entered chronologically, a cash disbursements book in which payments by check are recorded, and a petty cash journal in which cash disbursements of a minor nature are listed. The monthly totals are posted and summarized in the general ledger, from which periodic and year-end financial statements are prepared.

FIGURE 6
CASH RECEIPTS JOURNAL

		Bank #1	Bank #2	Accounts Receivable		General	
Date	Name			Case No.	Amount	Acct.	Amount

Trust Funds

Amounts received in trust or escrow should not be deposited in the regular office bank account. Funds received from settlement of law cases, real estate closings, etc., should be deposited in a special account. When acting as executor or trustee, the firm should open a separate account for each trust or estate.

Books of Account Peculiar to the Profession

Accumulation of Financial Data

Fundamental to all the books of account are the cost and time data which provide the basis for billing and resultant revenues.

FIGURE 7
CHART OF ACCOUNTS

BALANCE SHEET ACCOUNTS

Current Assets	Liabilities
1--Cash on deposit-regular	30--Accounts Payable
2 (a)--Trust Fund #1	31--Funds held for clients
(b)--Trust Fund #2	32--Federal withheld Taxes
3--Petty Cash Fund	33--State withheld taxes
5 (a)--Accounts Receivable-billed	34--City withheld taxes
(b)--Accounts Receivable-unbilled	35--Other payroll withholdings
6 (a)--Allowance for doubtful accts.	36--Misc. Taxes Payable
8--Cash advanced to clients	40--Accrued Liabilities
10--Advances to partners & employees	
12--Prepaid Expenses	

Capital Assets	Capital
20--Office Equipment	50 (a)(b)(c)--Capital Accounts
25--Library	55 (a)(b)(c)--Drawing Accounts
26--Leasehold improvements	60--Undistributed Profits or
27--Allowances for depreciation	Retained Earnings.

INCOME & EXPENSE ACCOUNTS

Income Accounts

70 (a)(b)(c)--Fees Earned
72 (a)(b)--Other Income

Expense Accounts

73--Principal's or Partners' Salaries

74--Associates' Salaries
75--Associates' Fee Participations
76--Office Salaries
78--Rent
79--Books & Periodicals
80--Telephone
81--Postage
82--Stationery & Supplies
83--Insurance
84--Light
85--Repairs
86--Payroll Taxes
87--Other Taxes
88--Prof. Dues & Meetings
89--Pensions & Employee Benefits
90--Contributions
91--Depreciation
92--Bad Debts
93--Miscellaneous Expenses
94--Absorbed Costs
100--Revenue & Expense Summary

Lawyers

When a new client is obtained, or a new case accepted, a New Client Memo is set up which gives preliminary information as to the matter (Figure 8).

This card is prepared in triplicate: one copy is kept on file, another is sent to the accounting department, and the third goes to the principal attorney. The initial details of the new client or matter are transcribed thereon. It is advisable that each partner and each case be given an identifying number. Partners may be identified by two digits, and cases with four digits, with the first two digits representing the client and the third and fourth digits the particular case. This identification may become particularly important should the firm decide to use a data-processing or computer service to maintain its records.

Time Records

The source of time charged to each engagement is originally derived from the personal diary kept by each lawyer. This is kept daily with notations as to hours and minutes worked on each case during the day, together with any out-of-pocket disbursements made (Figure 9).

From the daily diary, a Time and Expense Report is prepared for each matter handled that day which is the basis for billing (Figure 10). This is prepared in quadruplicate -- one for the files, and the others for the accounting department, the partner, and for internal control purposes.

From the contents of the Time and Expense Report, the billing partner and/or the accounting department can determine the time spent on the case and on the basis of the hourly billing charge accumulate the data for the eventual bill to be rendered, plus billable expenditures made.

TIME AND PAYROLL SYSTEM

A detailed record of each employee must be kept, showing gross salaries, and the various social security and income tax withholdings. Hours worked are required only for non-professional employees, although a breakdown may be useful where chargeable time is involved.

Dependent on the size of the firm, the one-write payroll system may be the simplest in providing the information required for preparing the various payroll tax returns.

FIGURE 8
NEW CLIENT MEMO

Name of Client Client _____

Address Indicate New Client

Description of Case: Old Client

File No._____

Date Opened:

Billing Partner (No._____)_____
Principal Attorney (No._____)_____
Associate or Staff (No._____)_____

File Copy

Accounting Copy

Partner's Copy

FIGURE 9
DAILY DIARY

MONDAY, FEBRUARY 2, 19xx

Hour	Client	Case	Services Rendered	Expense	Time Hours	Time Min.
8:00 a.m.	A	Incorporation of "A" Corp.	Met with Mr. A. Discussed details of corporation with Mr. A & CH, accountant.		1	15
9:00 a.m.	B	Draft of Will.	Discussed intent, size of estate, assets, bequests. Telephoned RW acct. for list of assets. Prepared general outline of will.		1	30

10:00 a.m.	B					
11:00 a.m.	C	Fed. Income Tax Examination. 19x2.	Conferred with Mr. I.S., internal revenue agent, at 90 Church St. office. Discussed case.		1	0
12:00	C	"	"	Lunch with agent, discussing case. Paid for lunch.	$ 8.75	1	0
1:00 p.m.	C	"	"	Returned to IRS office. Case settled. Tax return accepted as filed.		1	0
2:00 p.m.	C	"	"	"	"	45	
3:00 p.m.	D	Partnership agreement	Met with Messrs. D, E & F, regarding partnership agreement. Discussed details of investment in capital, profits & loss sharing ratio, etc.			2	0
4:00 p.m.		D, E & F.					
5:00 p.m.							
			Total Time			8	30
			Expenses		$ 8.75		

The payroll may be broken down into separate categories, such as associates' salaries, associates' fee participations, stenographers, typists, clerks, librarians, etc., to the degree required. Partners' salaries are kept separate. Adhering to the terms of the partnership agreement, any withdrawals in excess of stipulated salaries are entered in the partners' drawing accounts.

Accounts Necessary for the Professional Corporation

Other than the differences in the types of federal, state and local income and franchise taxes, the record-keeping changes occur primarily in the Salaries and Equity accounts.

Those who ordinarily would be partners in a partnership would be stockholder-employees in a professional corporation. No social security or income tax deductions are made from partners' salaries, nor does the firm remit payroll taxes to the government on their behalf. Since the principals or partners are now employees of a corporation, they are treated, for tax purposes, as all other employees, and their salaries are subject to all required payroll deductions.

In a partnership, each partner has a capital account and drawing account in his name, and his equity is increased by the excess of his share of the firm's earnings over his withdrawals. At the end of a fiscal period, his share of the net assets is reflected in the balance of his Capital account. The professional corporation, however, is treated in the same manner as other business corporations. The Capital Stock account represents the total investment by all the stockholders in the corporation. (A separate stockholders' ledger would show the number of shares owned by each stockholder). Any undistributed profits are reflected in a Retained Earnings account. The net worth of the corporation then is the sum of the Capital Stock account and the Retained Earnings account. Any withdrawals other than salaries are treated as dividends.

FIGURE 10
TIME AND EXPENSE REPORT

Client _____ Client No. _____

Case _____ Case No. _____

Attorney _____ Attorney No. _____

Time Spent _____ Hours _____ Minutes

Comments:

Expenses:

_____ Taxis _____
OFFICE MEMO Lunch _____
Other _____
Billable time: Total: _____
__hrs.__min. at $ per hr. $ ____

File Copy

Accounting Copy

Partner's Copy

Internal Control Copy

EXHIBIT 2-3
ATTORNEY-CLIENT PRIVILEGE

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. United States v. Hodge and Zweig.

HISTORY AND BASIC ELEMENTS

In The Matter of Edward E. Colton, Respondent, [62-1 U.S.T.C. 9189] (1961).

Colton v. United States, [62-2 U.S.T.C. 9658, CA 2nd Cir. (1962) aff'g *DC 62-1 U.S.T.C. 9189 (1961).*

FEE ARRANGEMENTS & CLIENT IDENTITY

Osterhoudt v. United States, [84-1 U.S.T.C. 9132] (1983) CA-9th Cir. aff'g an unreported DC decision.

United States et al v. Hodge and Zweig, [77-1 U.S.T.C. 9263] (1977) CA-9th Cir. aff'g *DC 74-2 U.S.T.C. 9781.*

United States et al v. Bruce Hartigan, [75-1 U.S.T.C. 9173] (1975).

United States v. Hodgson, [74-1 U.S.T.C. 9283] (1974).

Colton v. United States, [62-2 U.S.T.C. 9658] (1962) CA-2nd Cir. aff'g *DC 62-1 U.S.T.C. 9189.*

Tillotson v. Boughner, [65-1 U.S.T.C. 9261] (1965).

Contra, The identity of a client may be privileged when that information would in effect reveal the substance of a confidential communication. (Attorney cannot be compelled to reveal name of client on whose behalf attorney anonymously paid taxes.)

Baird v. Koerner, [60-2 U.S.T.C. 9527] (1960) CA-9th Cir. aff'g and reversing *DC 59-2 U.S.T.C. 9517.*

BURDEN ON THE CLAIMANT

In Reisman v. Caplin, the Supreme Court held that an Internal Revenue summons may be challenged on the ground of attorney-client privilege. However, the burden is on the taxpayer to prove that the information requested falls within the attorney-client privilege.

Reisman v. Caplin, [64-1 U.S.T.C. 9202] (1964) Sup. Ct. aff'g CA DC 63-*1 U.S.T.C. 9255 (1963)* Writ of Certiorari.

United States v. Kovel, [62-1 U.S.T.C. 9111] (1961) CA-2nd Cir.

vacating and remanding unreported DC decision.

United States v. Johnson, [72-2 U.S.T.C. 9657] (1972)

United States v. Gurtner, [73-1 U.S.T.C. 9228] (1973) CA-9th Cir. aff'g unreported DC decision.

FINANCIAL STATEMENTS

Only confidential records are protected, information given to attorney to prepare income tax returns is not confidential.

United States v. White, [73-1 U.S.T.C.] (1973) CA-5th Cir. aff'g DC 71-*2 U.S.T.C. 9577.*

Colton v. United States, [62-2 U.S.T.C. 9283] (1962) CA-2nd Cir. aff'g *DC 62-1 U.S.T.C. 9189.*

United States v. Charles L. Abrahams, [90-1 U.S.T.C. 50,310] (1990) CA-9th Cir. aff'g in part, vacating in part and remanding an unreported DC decision.

United States v. Ned Willis, [83-1 U.S.T.C. 9398] (1983).

Robert Van Drunen v. United States, [90-1 U.S.T.C. 50,303] (1990).

ATTORNEY-CLIENT TRUST FUND

United States v. Union First Bank of Washington, [80-1 U.S.T.C. 9379] (1980).

INFORMATION RETURNS -- *IRC 6050I* FORM 8300

United States v. Goldberger & Dubin, P.C., [91-2 U.S.T.C. 50,315] (1991) CA-2nd Cir. aff'g an unreported DC decision.

FEDERAL LAW

Federal, not State, law applies in determining whether the privilege exists (Government's Position per District Counsel).

Colton v. United States, Supra.

United States v. Hodge & Zweig, Supra.

United States v. Cromer, [73-2 U.S.T.C. 9522] (1973) CA-9th Circuit Affirming unreported DC decision.

ENFORCEMENT OF SUMMONS: ATTORNEY-CLIENT PRIVILEGE

Summonses must be issued in Good Faith.

Donaldson v. United States, [71-1 U.S.T.C. 9173] (1971), Sup. Ct. aff'g (CA-5) *69-2 U.S.T.C. 9701.*

Colton v. United States, Supra.

United States v. Hartigan, Supra.

United States v. Hodge & Zweig, Supra.

Dallas L. Holifield v. United States, [90-2 U.S.T.C. 50,423] (1990) CA-7th Cir. aff'g a DC decision, *88-2 U.S.T.C. 9472.*

Summons Overbroad:

United States v. Marvin L. Tratner, [75-1 U.S.T.C. 9259] (1975) CA-7th Cir. aff'g and remanding unreported DC decision.

CHAPTER 3

AUDIT STEPS
PRE-AUDIT ANALYSIS

A comprehensive pre-audit analysis is essential in performing an effective audit of any case. Given the nature of the cases being audited through the attorney project, that is nonfilers or noncompliance filers, an even more thorough search of available data is necessary. Sources of records to be researched vary from state to state, but most are available. Both asset searches and income searches are discussed.

Asset Searches

1. THE DEPARTMENT OF MOTOR VEHICLES

Data is available detailing driver's licenses issued to individuals and registration information on vehicles, including off- road and boats (under 50 feet) owned or leased by individuals.

Driver's license information is updated by the individual and is only as current as the last renewal, possibly 4 years earlier. It generally shows a residential address and also contains a physical description of the individual and a date of birth.

Vehicle registration data reveals the original purchase date of the vehicle, latest renewal, type, make, VIN, license plate, and lender/lessor, if any. Note that lenders and lessors have a lease application file, which may be a source of bank accounts.

Boats must be registered with the U.S. Coast Guard if over 50 feet in length, or 13 tons. Smaller vessels are registered with the Department of Motor Vehicles (DMV). Owners may register large vessels with the DMV in addition to the Coast Guard.

2. COUNTY OFFICES FICTITIOUS NAMES FILES

The county maintains files and a listing of all individuals, partnerships, and other associations and corporations who regularly transact business for profit, if that county is the principal place of business. Known as "dba" (doing business as), or "fictitious name" file, this source can be important in identifying previously unknown operations. A fictitious name is defined or suggests the existence of additional owners. Any partnership name which does not include the surname of each general partner or that suggests the existence of additional owners is also considered fictitious. Corporate fictitious names are those not named in the articles of incorporation.

Organizations not included are non-profit or real estate investment trusts (REITs) which have statements on file designating the agent for service of process. An index by registrant's name and another by the fictitious business name lists file numbers for those entities or individuals. Files maintained may be viewed by the public and include the fictitious business name, address of principal place of business, full name of registrant, and residence address.

3. PROPERTY RECORDS

The county maintains records of taxes and ownership of real and business personal property. Several offices with different functions may need to be contacted to determine the full extent of real and personal property owned or previously owned by the taxpayer (or nonfiler).

a. THE COUNTY ASSESSOR

The assessor is responsible for identifying all taxable property in the county, describing such property, identifying the owner(s), maintaining records listing property and owner(s), determining a value for the property, and listing the value on the assessment roll. The assessor is not responsible for collecting the taxes as that falls to the tax collector's office. Specific information about real property, available on the assessor's roll includes:

-- owner of record as of lien date

-- mailing address of the owner

-- assessed values (change when ownership does)

-- full value

-- exemptions: home owner's, church, etc.

-- net assessed value

-- vesting as it pertains to how property is held.

Information is kept by alphabetical listing of owners, by parcel number, and by property address.

Business personal property is reappraised annually. Business owners are required to provide a property statement each year detailing costs of all supplies, fixtures, and equipment. Inventory is not valued or assessed. Other property values are readily available; however, a summons will be required to gain access to purchase information. These files also include information on boats and airplanes held in a business name. Registration of boats was covered in the DMV section. Airplanes must be registered with the Federal Aviation Agency (covered later in this paper).

b. THE TAX COLLECTOR'S OFFICE

This office collects real and personal property taxes assessed by the assessor's office. Information is separated into secured (real estate) and unsecured (everything else). Useful information available from this source includes:

-- property tax bills

-- date paid

-- delinquent taxes due

-- photocopies of checks used to pay taxes.

Information other than delinquent taxes will require a summons. Note that check photocopies can be used to determine the party actually paying the tax, possibly identifying a nominee owner, and bank accounts.

c. MICROFICHE RECORDS

Some Post of Duties (PODs) maintain microfiche records of real property transactions within the county for the past several years. If those are available, they provide an excellent starting point for searching real property records. Keep in mind that they reflect only a specific point in time. If multiple transactions took place within a time period, only the most recent will be listed. Microfiche are useful for determining property ownership both current and historic, as well as listing the transfer value, and in some cases, the loans incident to the sale. Ownership and transactions are cross-referenced by parcel number, owner's name, and property address.

If the search of real property records needs to be expanded or the POD does not have ready access to microfiche records, the County Recorder's office has more complete information, listing every transaction filed. This will expose transactions that microfiche will not. Types of transactions filed here are:

-- real estate purchases

-- sales and transfers

-- deeds

-- trust deeds & reconveyance

-- partnerships agreements

-- powers of attorney

-- lis pendens

-- abstract of judgement.

These records are useful to agents who are attempting to determine the actual value of the property (via the documentary tax of .0011 of full value) and have particular application to those attorney audits where payment for services may be in the form of a trust deed or in cases where taxable gain from a sale or exchange was never reported.

For real property searches outside of the county, research becomes slightly more difficult. Travel to the county where records are suspected or known to be located is expensive and time-consuming. Attempting to locate another agent willing to do the search for you is also less than efficient. Those locales which have access to one of the computerized data bases, such as Dataquick or Damar, have an option which may be preferable. These data bases are accessed via computer terminals in the PODs in the Laguna Niguel District. They provide real estate information on a statewide basis as well as property ownership in other states. As with most data bases, a fee is charged on a time basis.

4. COURT RECORDS

Court files are a useful source of information -- detailing divorce actions, bankruptcies, and lawsuits. Divorce files are open to the public, and computer database records are available for viewing, as are microfiche of older cases. In cases concerning child or spousal support, both parties are required to file an Income and Expense Declaration. These are also generally filed for more complex or contested cases where children or support are not issues, but property division is. The judge may also order parties to provide a balance sheet if he or she deems it material to the case. This may point out bank or investment accounts, as well as previously undisclosed real or personal property. In California, the Family Court keeps divorce files.

5. THE FEDERAL AVIATION AGENCY (FAA)

This agency maintains a database on all aircraft in the United States. Its files are open to the public and can be accessed via telephone, fax, or mail. More detailed information is available when inquiries are made by mail or fax, but a telephone inquiry will provide information concerning:

-- current registered owner

-- make

-- model

-- registration number (tail"N"#)

-- serial number (similar to VIN).

A hard copy inquiry will disclose other information that is on file including:

-- application for registration

-- bill of sale name

-- name and address of owner

-- buyer/seller

-- complete chain of ownership,

-- mailing address of owner

-- may also include lien information.

Address and phone: FAA Aircraft Registry
P.O. Box 25504
Oklahoma City, OK 73125
(405) 680-3116
(405) 680-3548 FAX

Income Searches

Income information is available from a variety of sources, some of which are discussed here.

1. CURRENCY AND BANKING RETRIEVAL SYSTEM

To track the flow of cash, the Federal Government has imposed more stringent reporting requirements in recent years. Several forms are of interest to revenue agents.

The first, Treasury Form 4789, Currency Transaction Report, is for cash transactions (deposits and withdrawals) over $ 10,000 with financial institutions, and is filed by the bank or S

& L. It identifies the individual making the transaction, the person or organization for whom the transaction was conducted, and the institution reporting, as well as the amount of money involved.

Customs Form 4790 details the international transportation of currency or monetary instruments. Persons transporting either of these must declare themselves to Customs when leaving the United States or when entering with funds to be declared from ex-U.S. sources. Persons who mail or ship funds also must complete Form 4790.

Treasury Form 8300 is a report of cash payment over $ 10,000 (U.S. dollars or foreign currency equivalent) received in a trade or business. It is to be filed by businesses receiving funds, identifies the customer, and provides a description of the transaction and method of payment.

Treasury Form 8362 is a report by casinos of currency transactions and again, lists the individual or organization involved, details of the transaction, and the reporting entity.

Treasury Form TDF 90-22.1 is required of all entities having a financial interest in or signature authority over foreign bank and financial accounts with an aggregate value of more than $ 5,000.

Printouts of any transactions reported may be obtained via modem from the CBRS in the Detroit Data Center.

2. THE U.S. BANKRUPTCY COURT'S CHAPTER 13 TRUSTEE

The trustee distributes funds in accordance with court orders. The trustee makes disbursements of legal fees directly to the attorneys and keeps a record in the form of a monthly check register. The Trustee's office may be willing to provide photocopies of their records.

3. RETURN PREPARER LISTINGS

These lists which detail all returns that have been prepared by a particular preparer, may be obtained from the Service Center through the Return Preparer Coordinator. These are useful in cases where the attorney performs tax services for clients, pointing out potential new cases as well as trends in preparation.

4. IRP TRANSCRIPT

This printout details Forms 1099 reported to the IRS. It lists interest and dividend paying accounts, potentially leading to unknown bank accounts or investments. Social Security payments are listed. The IRP transcript may also report Form 1099 rental income and property sales. Both Social Security and Employer Identification Numbers need to be requested for a complete report.

Information Document Requests

A working copy of an IDR which may be utilized is attached as Exhibit 3-1. This can be altered or expanded to fit the attorney's practice.

A list of suggested items to request for a bank summons is included as Exhibit 3-2.

INITIAL INTERVIEW

The initial interview is, perhaps, the most important step of the audit process. It is particularly important when dealing with attorneys since it may be the only opportunity to meet with the taxpayer directly. Direct testimony of the taxpayer is needed for two reasons. First, the

taxpayer's responsibility for financial transactions needs to be established, and secondly, a representative will not generally have adequate knowledge of the attorney's practice. In those instances where the taxpayer is not available or is unwilling to be interviewed, the agent may [wish to review IRR 301.7605, concerning the time and place of] examinations. Thought may also be given to the necessity of summoning the taxpayer. If this course of action is pursued, it should be discussed with management.

The interview must be well thought-out and carefully worded so the information the taxpayer is providing can be effectively evaluated. Attorneys tend to answer questions literally and offer little additional information. The tax return and all pre-audit information should be carefully considered. While reviewing the return, keep in mind that neither a low DIF score nor a return apparently free of problems is necessarily an indication of low audit potential. For example, the examination of a return with a low DIF score resulted in unreported income of $ 40,000. Known trouble spots such as unreported income and advanced client costs are not always immediately detectable.

A pro-forma initial interview outline is included as Exhibit 3- 3. Notes should be added regarding specific questions to be asked based upon the pre-examination analysis. During the interview use the pro-forma as a guideline only, asking follow-up questions based on the taxpayer's responses.

Questions which reveal how the practice started and areas of specialization will give insights into probable systems of accounting, the size and scope of the taxpayer's practice, and what sorts of income and operating costs to expect. For instance, if an attorney handles strictly personal injury cases, most income will be in the form of checks from insurance companies. Attorneys practicing criminal law will be more likely to receive cash or nonmonetary compensation.

An effective income probe is crucial since unreported income is often an issue. All possible sources of income need to be identified and explained so that they cannot be introduced as explanations later. Questions to ask which are particularly relevant when dealing with attorneys 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 other than cash?

-- Are there any foreign accounts or offshore interests?

-- Are there any interests in other entities?

A thorough understanding of the taxpayer's bookkeeping system and internal controls is necessary. Have the attorney or the bookkeeper step through the recordation process from the point where the attorney is retained by a client to the settlement of the account. Clearly determine the taxpayer's level of involvement in bookkeeping, check writing, and trust account activity to prevent the attorney from later passing responsibility for problems and discrepancies to the staff. This is important if fraud becomes an issue. Commonly an attorney handles the trust accounts personally, but other duties may be delegated. One attorney, at each discrepancy questioned, calmly stated, "My girls did it." If the taxpayer is not involved in the bookkeeping, find out who is and arrange to speak with that person.

Accounting systems vary widely depending on the diligence of the attorney in recording transactions and the types of law practiced. For example, personal injury attorneys seldom

receive any fee until settlement of a case. They often advance client costs such as medical expenses, court costs, and living expenses paid in anticipation of settlement. Question the treatment of these expenses on the books and the tax return. Advanced client costs are generally not deductible but they frequently appear as an expense on the tax return. This issue is discussed in a later section. Criminal attorneys usually arrange for clients to pay their own costs. They are often paid in cash and sometimes receive noncash compensation such as trust deeds or other assets.

Ask for the bank records for all accounts including any investment accounts. In one instance, a taxpayer volunteered information for three bank accounts. From court records of his divorce proceedings, bank statements for 62 additional accounts were summoned. Question the taxpayer about the use of each account. Depending on the size of the practice and the level of sophistication of the books, a number of different accounts may be used to pay expenses and deposit receipts. It is easier to ask up front and verify the information given than to try to decipher the numerous accounts later.

Request package audit information regarding any returns required to be filed. These may include payroll tax returns, Forms 1099 and Forms 8300. Exhibits 3-4, 3-5, and 3-6 provide examples of workpapers that may be used for these information returns. At the conclusion of the initial interview, you should have an understanding of the taxpayer's system of accounting, his or her level of involvement in that system, and who to go to with questions 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. The scope of the examination can now be set.

EXHIBIT 3-1

Department of the Treasury Request Number
Form 4564 Internal Revenue Service
Rev. Jan. 1984 INFORMATION DOCUMENT REQUEST

Subject:
TO: (Name of Taxpayer and Co. Div. or Branch)

SAIN No. Submitted to:

Please return with listed documents to requester listed below. Dates of Previous Requests

---

Description of Documents Requested:

Please have the following records available at our appointment: The items checked (X) are needed, but are not intended to be all inclusive; additional items may be required at a later time.

( ) 1. All books and records: Cash receipts and disbursements journals, appointment book, client's card index, daily log or receipts book, journal of receipts and disbursements from trust funds, payroll journal, subsidiary ledgers, and chart of accounts.

( ) 2. Bank statements, cancelled checks, and deposit slips for all personal, business and trust accounts for the periods 1/___ through 1/___. Bank reconciliation statement for the last month of the calendar year for both business and trust accounts. Documentation of invested funds.

( ) 3. Workpapers used to prepare/reconcile books with the tax return.

( ) 4. Client ledger cards for the year(s) under examination.

( ) 5. Copies of Forms 1040 for 19__ and 19__.

( ) 6. Copies of Forms 8300 filed for the examination year.

( ) 7. Employers quarterly tax returns -- Federal and State (Forms 940, 941, and DE-3) for the year under exam to the present.

( ) 8. Employee(s) Forms W-2 and W-4 for the year under exam and all Forms 1099 received and issued.

( ) 9. Invoices covering all acquisitions and dispositions of capital assets during the examination year and verification of basis of assets shown on the depreciation schedule.

( ) 10. Travel & entertainment substantiation as required by IRC section 274 -- diary, itinerary, invoices, cancelled checks, names, dates, business purpose, etc.

Name and Title of Requester Date

From: ----------

Office Location: Phone:

EXHIBIT 3-2

BANK DOCUMENT REQUEST LIST

1. All open or closed checking, savings and NOW accounts:

   a. Signature cards
   b. Bank statements
   c. Cancelled checks -- front & back
   d. Deposit tickets & items
   e. Credit and debit memos
   f. Wire transfer records
   g. Forms 1099 or back-up witholding statements.

2. Retained copies of all open or closed bank loan or mortgage documents:

a. Loan application
b. Loan ledger sheet
c. Copy of loan disbursement document
d. Copy of loan repayment document
e. Loan correspondence file
f. Collateral agreements
g. Copies of notes or other instruments reflecting the obligation to pay
h. Copies of real estate mortgages, chattel mortgages, or other security for bank loans
i. Copies of annual interest paid statements
j. Copies of loan amortization statements
k. Copies of any and all documents in loan package records.

3. Certificates of deposit (purchased or redeemed):

a. Copies of the certificates
b. Records pertaining to interest earned, withdrawn or reinvested
c. Forms 1099 or back-up witholding statements

4. Open or closed investment or security custodian accounts:

a. Documents reflecting purchase of security
b. Documents reflecting negotiation of security
c. Safekeeping records and logs
d. Receipts for receipt or delivery of securities
e. Copies of annual interest paid statements.

5. All open or closed IRA, Keogh, and other retirement plans:

a. Account statements
b. Investment, transfer, and redemption confirmation slips
c. Documents reflecting purchase of investment
d. Documents reflecting redemption of investment
e. 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:

a. Fed wire, Swift, or other documents reflecting transfer of funds to, from, or on behalf of (the subject's name)

b. Documents reflecting source of funds for wire out
c. 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:

a. Applications for credit card
b. Monthly statements
c. Copies of charges
d. 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.

Note: This language has been approved by District Counsel for use on summonses to financial institutions.

EXHIBIT 3-3

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

==========

INITIAL INTERVIEW AND HISTORY OF BUSINESS

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PERSON(S) INTERVIEWED:

CURRENT ADDRESS: BUSINESS PERSONAL

CURRENT PHONE NUMBERS: BUSINESS PERSONAL

PRIOR AUDIT: ISSUES:

HISTORY OF BUSINESS:

HOW DID BUSINESS START:

WHEN:

AREA OF LEGAL SPECIALTY:

LICENSED TO PRACTICE IN ANY OTHER STATES:

GEOGRAPHIC AREA OF PRACTICE:

OTHER OFFICE LOCATIONS:

MANAGER IN CHARGE OF LOCATIONS:

HAVE YOU FILED OR PLAN TO FILE FOR BANKRUPTCY:

PAYROLL:

HAVE ALL PAYROLL RETURNS BEEN FILED TO DATE:

WHO HANDLES PAYROLL RECORDS:

WHO PREPARES PAYROLL RETURNS, FORMS W-2 AND 1099:

ARE FORMS 1099 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:

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:

DO YOU RECEIVE REFERRAL FEES FROM OTHER ATTORNEYS:

EVER RECEIVE COMPENSATION OTHER THAN MONEY: (i.e. 2ND TD OR DEBT CANCEL)

DO YOU FURNISH SERVICES IN EXCHANGE FOR GOODS OR SERVICES:

DO YOU DO PRO BONO WORK OR WORK ON A SLIDING SCALE:

HOW TIME KEPT TO ARRIVE AT BILLING AMOUNT:

TYPES OF PAYMENT PLANS:

EVER RECEIVE CASH PAYMENTS:

HOW MUCH AND HOW RECORDED:

OVER 10,000 RECEIVED:

DEPOSITED TO WHICH ACCOUNT:

FORMS 8300 FILED: (get copies) DO YOU NOTIFY CLIENTS AT YEAR END:

UNDERSTANDING OF RESPONSIBILITY TO FILE:

WHO IS RESPONSIBLE FOR FILING:

ACCOUNTING SYSTEM: CASH ACCRUAL OTHER

BOOKS AND RECORDS:

WHAT RECORDS ARE KEPT: CHART OF ACCOUNTS _____
GENERAL LEDGER _____
CASH RECEIPTS JOUR _____
CASH DISBURS JOUR _____
ACCOUNTS REC/PAY _____
CLIENT LEDGER CARDS _____
ONE WRITE CHECKS _____
SPREADSHEET OF EXPS _____
CHECK REGISTER _____
SOURCE DOCUMENTS _____ (invoices, stmts, etc)
MONTHLY BANK RECON _____ (bank stmts, ccs, dep slips)
P&L STATEMENTS _____
W/P FOR TAX PREP _____
OTHER _____

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 QTRLY YEARLY

WHO PREPARES: IF PREPARED BY ACCOUNTANT, WHAT INFORMATION IS GIVEN AND HOW REGULARLY

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: (INC CASH)

ANY DEPOSITS LESS CASH:

HAVE YOU RECEIVED ANY PAYMENTS BY WIRE TRANSFER OR DIRECT DEPOSIT:

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:

BUSINESS PERSONAL

CASH ON HAND BOY:

CASH ON HAND EOY:

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 TP:

INVESTMENT IN OTHER ENTITIES:

TRUSTEE OF ANY TRUSTS: (BUSI OR PERS)

BENEFICIARY OF ANY TRUSTS:

PURCHASE ASSETS FOR ANYONE ELSE:

OWN ANY INTEREST IN REAL PROPERTY:

ANY DEDUCTION, INCOME ITEM OR CREDIT DISCOVERED WHILE PREPARING FOR EXAM:

QUESTIONS REGARDING SPECIFIC EXPENSES:

CLOSING:

AUDIT TRAIL: WALK THROUGH RECEIPTS AND DISBURSEMENT TRANSACTIONS

NAME OF PERSON TO SUPPLY INFORMATION DURING AUDIT:

REVIEW INITIAL IDR WITH TAXPAYER

EXHIBIT 3-4

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

COMPLIANCE CHECK

REQUIRED RETURNS: HAVE ALL BEEN FILED

WAGES & SALARIES: Forms W-4 Inspected
Forms W-2 Inspected
All employment tax returns timely filed
941-940 agree to tax return

FORMS 1099 FILED

8300 COMPLIANCE CHECK

PRIOR & SUBSEQUENT YEAR RETURNS

BOOKS TO RETURN

RELATED RETURNS

MINUTE BOOK

OFFICER COMPENSATION

EXHIBIT 3-5

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

COMPLIANCE CHECK/1099 CHECK

Precontact Analysis: Request PMFOL if outside labor or independent contractors on return

Forms 1099-Total to Form 1096

Form 1096 total matches to books

Forms 1099 inspected for correct/complete information

If information missing, does taxpayer have in files

Inspect C/D to determine that all required payments are reported on Forms 1099 or W-2

Are Form 1099 payments actually wages

Any penalties due

Followup on payees

EXHIBIT 3-6

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

COMPLIANCE CHECK/8300 CHECK

CBRS/financial documents requested during precontact analysis

Is this a high potential cash business

Initial Interview: receipt of cash and taxpayer's knowledge of 8300 requirements discussed

Bank deposits, C/R journal and sales invoices inspected for cash receipts

C/D journal and purchase invoices inspected for expenses paid by cash

CBRS cash transactions traced to books

Any penalties due

Followup on payors

CHAPTER 4
AUDIT ISSUES
GROSS INCOME

Law firms, being service-oriented businesses, typically use the cash receipts and disbursements method to determine income for tax purposes. Generally, the calendar year is used as their reporting period. Law firms vary in size from the individual practitioner to large corporations or partnerships. In addition, law firms may differ in the type of work they do. There is the general law practice which will handle many types of cases. Other firms may engage in specialities such as corporate law, bankruptcy, criminal law, personal injury, or estate planning. The type of legal work that is done affects how and when income is determined.

The first step in auditing income is to determine the type of legal work that is handled and the payment arrangements with clients. Some attorneys base their fees on a percentage of the settlement (contingent fee). 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 since these are the basis for their billings. The fees and costs can also be traced to individual client ledger cards.

GROSS INCOME TYPES

While time is generally the basic standard for setting fees, there are various arrangements by which attorneys earn income. The following is a summary of the most common types:

Specific Retainer

This is an agreed fee for a particular case, part of which may be payable in advance. The attorney typically sets a fee in writing with the client for a prescribed dollar amount per hour plus costs. There is a predetermined amount of money due before the case is accepted. This advance payment is commonly deposited into a trust account. The attorney then transfers part or all of the money from the trust account to the general account as it is earned. If the attorney is on a cash basis of accounting and has free access to the funds, the retainer is taxable when received.

The client is normally given a periodic accounting of the time and costs spent on the case. If the trust fund is exhausted, the client is billed for any balance due. Typical cases involving this type of arrangement are divorces, drunk driving cases, business incorporations, and immigration cases.

Annual Retainer

This is also an agreed and fixed fee, but it covers services over a specified period of time, generally a year. Additional provisions may be made for supplementary fees for special or unusual services. This is generally spelled out in a written contract between the parties. The annual retainer type of arrangement is often used for corporate clients. The attorney produces the annual corporate minutes and provides advice on various business matters. Supplemental fees are earned on actual litigation work undertaken on behalf of the client. Again, a cash basis taxpayer should report this as income when received.

Contingent Fee

This arrangement involves a certain agreed upon percentage of the dollar amount recovered for the lawyer's client in settlement or litigation of a case. 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. The attorney generally receives one-third of the recovery, but the contingency amount may vary according to whether the case is settled or resolved in actual litigation. The total settlement is deposited into the attorney's trust account. The attorney then has the responsibility of disbursing the funds on behalf of the client. The disbursements may include medical costs, 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.

Referral Fee

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. Questions should be asked about any cases referred to another attorney. These fees represent recognizable income when received. This type of arrangement may be seen in class action suits where one attorney represents a number of litigants who may also have their own referring attorneys. Worker's compensation suits are an example of cases which may require a specialized attorney.

CLIENT TRUST ACCOUNTS

Most attorneys will have one or more trust accounts under their control (see Chapter 2 on "Bank Accounts"). These should be reviewed in conjunction with the regular business accounts

and personal accounts. Adjustments to taxable income most frequently arise when an attorney diverts funds from a trust account to a personal account or defers income by allowing fees to remain in a trust account.

Unreported Income

When an attorney receives a settlement on a case, the entire amount is deposited into the trust account. The settlement check is generally made out in the names of the attorney and the client. It is then the attorney's responsibility to distribute the proceeds. Frequently, the attorney is required to write a check to himself or herself to cover his or her fees and case costs. This occurs when a case is taken on a contingency basis.

It is important to ascertain whether the fees have been included in income. Some attorneys either cash the checks or deposit them directly into personal or investment accounts. If they determine taxable income by totalling deposits made into the general operating account, these fees are omitted from income.

Inspecting the endorsements on checks written to or on behalf of the attorney from trust accounts is one important auditing procedure. These checks all represent income or expense reimbursements. Special attention should be given to all checks that are deposited into accounts other than the general operating account or are cashed. In addition, as observed in one audit, funds may be withdrawn directly through the use of an ATM card. The funds were never reported as taxable income even though they were used for personal expenditures.

Deferral of Income

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 determinable and available and should be included in income. An effective audit step is to analyze the source of funds remaining in the trust account at year end. This is an important step if there is a large balance. Determine whether any of the funds in the account represent fees which have been earned on settled cases.

NONCASH SOURCES

There are a number of sources of noncash income that an attorney may have, depending on his specialty or the particular work done for a client. An attorney who does real estate work may accept a second or third trust deed on a client's property in exchange for legal fees. A client may also quitclaim a partial or entire interest in a property in exchange for legal fees. An attorney can also be paid for his services through a sale or purchase escrow of the client. Examination of the client ledger cards will many times lead to the discovery of these situations.

For example, one attorney borrowed a large sum of money from a corporate client and 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.

An attorney who renders services to set up partnerships or corporations may accept an interest in the entity in exchange for legal services. Again, an examination of client cards may show this or you may request verification of basis for partnerships shown on the attorney's return.

OTHER GROSS INCOME AUDIT AREAS

Unreported income was discovered in the audit of a bankruptcy attorney. All attorney fees in Chapter 13 cases are disbursed by a U.S. Bankruptcy Trustee under court orders. It is not necessary for the attorney to bill clients in these cases since all fees and their disbursements are determined by the courts. The Trustee does not issue Forms 1099 to the attorneys. The Trustee's controller may be [sic] was willing to provide access to the monthly check registers. This may establish the attorney's fee income from Chapter 13 cases.

Cash payments for legal services can be diverted to other accounts or to other entities under the control or for the benefit of the attorney. Cash payments may not all be deposited or reported. Some attorneys are purported to offer substantial legal service discounts for currency payments. Cash Transaction Reports should be requested and analyzed, particularly where the use of cash is observed or suspected. The examiner should also be aware of cases where an indirect method may be needed to determine income. Indirect methods are discussed in Chapter 800 of IRM 4231.

A case was encountered where a criminal attorney chose to delay receiving income for the second half of the year. The 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. Since billings were submitted only for the first half of the year, the attorney's gross income income was considerably understated.

In cases such as these, 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 this right to receive it. (*Treas. Reg. section 1.451-2*.) Simply stated, taxpayers may not ignore income which is made available to them.

Unreported income may not be obvious from a pre-audit analysis or during the initial interview with the attorney. Sufficient economic resources may be reflected on the surface to cover the deductions claimed. The examiner should perform a thorough pre-audit analysis including property searches and order 0IMS data on other years. A solid initial interview is essential to determine the attorney's credibility, legal specialties, internal accounting controls, and a working knowledge of the books and records.

EXPENSES

Lavish and extravagant

Lavish and extravagant simply means something unreasonable. Entertainment expenses will not be disallowed as lavish or extravagant merely because they exceed a fixed dollar amount or are incurred at deluxe restaurants, hotels, nightclubs, and resort establishments.

An observation made in the RIA Federal Tax Coordinator is that, "No reported case or ruling has denied a deduction on the ground that the expenditure was lavish or extravagant." Therefore, the entertainment expense must be questioned as to its reasonableness, whether it is ordinary and necessary per *IRC section 162*, whether it meets the "directly related" and "associated with" tests, and whether it meets the substantiation requirements of *IRC section 274(d)*. The taxpayer should then substantiate such expenditures in accordance with the rules under *IRC section 274(d)* and the "directly related" and "associated with" tests as outlined in Treas. Reg. section 1-274-2(1)(i) & (ii).

Entertainment, Promotion, and Advertising

Generally entertainment, promotion, and advertising expenses are areas which give rise to audit issues. In one case, deductions in excess of $ 60,000 over a 3-year period were claimed for rock and roll concert tickets purchased from scalpers for front row center seats. The attorney claimed that by taking doctors, fellow attorneys, and potential clients to concerts with first class seating, limousine service, dinner, and cocktails, he gained exposure to rock and roll groupies, roadies, and stars. Therefore, people in the music business would come to him when they needed an attorney. The reasonableness of his assertion is arguable.

Entertainment

Whether the taxpayer calls the expense promotion, advertising or entertainment, it will generally fall into the classification of entertainment. *Treas. Reg. section 1.274-2(b)(1)(i)* defines "entertainment" as any activity which satisfies the personal, living, or family needs of any individual; for example, providing food and beverage, a hotel suite, or an automobile to a business customer or his family. Included is entertaining at a social gathering at home, at night clubs, cocktail lounges, theatres, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips. Entertainment is subject to the "directly related" and "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 night clubs, theatres, sporting events, cocktail parties, or social gatherings.

In *Israelson v. United States, 74-1 U.S.T.C. 9150* (1973 DC Md), 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.

The following cases denied deductions for entertainment where the taxpayer failed to meet the "directly related" and "associated with" tests in which goodwill was derived from a purely social setting:

-- *Walliser v. Commissioner, 72 T.C. 433 (1979)*

-- *Flaig v. Commissioner, 47 T.C.M. 1361 (1984)*

-- St. Petersburg Bank & Trust v. United States, 362 F. Supp.

674 (DC-Fla. 1973) *(73-2 U.S.T.C. 9683),* aff'd *503 F.2d 1402*

-- *J. Gardner v. United States, 45 T.C.M. 1116*

The following cases also denied deductions for promotion based on lack of proof:

-- *S. Broughton v. Commissioner, 21 T.C.M. 1448 (1962)*

-- *F. Kilgannon v. Commissioner, 24 T.C.M. 619 (1965)*

-- *R.A. Roumiguire v. Commissioner, 40 T.C.M. 1137 (1980)*

Travel

Another area where audit issues are common is travel expenses. Some attorneys have motor homes or other recreational vehicles and freely use them on trips. These expenses are personal in

nature and are not deductible as business expenses. In addition, personal vacations, touring with a rock group, honeymoons, political and goodwill trips, have also been found under the guise of business travel. Taxpayers are often unable to substantiate the trips as required by *IRC section 274*.

One attorney substantiated air fare and lodging for several ski trips. When asked the business purpose he refused to answer, claiming the attorney-client privilege (see prior discussion of "Attorney-Client Privilege"). The documents provided, however, created suspicion when they included the names of his children and wife. Some attorneys are licensed to practice in other states and may legitimately have business travel, but they are still required to provide proper substantiation.

Disguised Hobbies

The attorney should be asked about hobbies during the initial interview. That information may prove to be valuable in the audit of expenses. Many self-employed attorneys have enough income to afford the luxury of very expensive hobbies. Payments for hobbies will often turn up on tax returns as some sort of business expense. For example, one attorney said his hobby was fine wines. He and two other associates had a wine cellar they had built and continually stocked with wines from all over the world. It was observed that deductions had been claimed under office supply expenses for wine purchases. Other hobby expenses found to be deducted involved a charter fishing boat activity, polo ponies, and antique cars.

Corporate Expenses

Constructive dividend issues are often present when auditing a personal service corporation, and attorneys are no exception. One attorney, who was referred for fraud, claimed his income from his corporation was $ 11,000. Upon further examination of the corporation, it was found that he did not need to be paid more because the corporation paid all of his personal living expenses. The examination resulted in a constructive dividend to the shareholder of over $ 200,000 per year.

Attorneys who are corporate shareholders often use a company credit card for travel and entertainment. Personal expenses are frequently charged on those cards and paid by the corporation. Constructive dividends for personal expenses paid by the corporations should be considered when auditing attorneys who are shareholders.

Depreciable Books and Periodicals

The general rule for depreciating property is found in *IRC section 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. According to CCH, 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. 87-57).

Advanced Client Costs

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 basis. They are generally on a cash basis of

accounting. The expenses are deducted when paid, and the recovered costs are included in income when received. This causes a distortion of income since it can take years to settle the cases. In addition to paying case-related costs, the attorney may also advance funds to a client to cover living expenses while the case is pending. Frequently, this expenditure is also deducted from taxable income.

It has been determined by the courts that advances to and costs paid on behalf of a client are to be treated as 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 recovery. 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 4-1.

The typical expenses included in this category are listed in *Canelo v. Commissioner, 53 T.C. 217 (1969),* at page 219:

> 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.

It is explained in *Herrick v. Commissioner, 63 T.C. 562 (1975),* at page 569 that:

> * * * the clear inference * * * of 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.

Therefore, while Canelo, might be read to encompass any expense for which an attorney expects to be reimbursed, 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, copying costs, transportation 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.

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. There is generally a ledger card kept on each client which shows the expenses paid on behalf of that client. When the recovery is included on the cash receipts journal, it is usually shown separately from the fee income associated with the case.

Advanced client costs may appear on the tax return in various places. Generally, the deduction will be taken under "other expenses" and will be labelled 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.

In the audit of any attorney, 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 finalized. 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 the clients to pay costs up front, this may not be a material issue that requires adjustment.

Although the court cases strongly support treating advanced client costs as loans, there are some arguments presented by the taxpayers and their representatives.

The argument most frequently raised is that if the advanced costs are to be treated as loans, the recovery of these "loans" does not create taxable income. This issue was raised in the Canelo case and was originally supported in the taxpayer's favor. The Government used the tax benefit rule to tax the attorney on recoveries of costs which had been deducted in years barred by the statute of limitations and reimbursed in later years. The court used an exception to the tax benefit rule and determined that it could only be used in cases in which a proper deduction had been taken originally. There are several Actions on Decision which address this issue. A Revised Action on Decision, CC-1981-175 overturns the earlier decisions. It was determined:

> 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.

This decision is affirmed in *Unvert v. Commissioner, 72 T.C. 807 (1979),* aff'd *(81-2 U.S.T.C., 9667) 656 F.2d 483* (9th Cir., 1981).

This argument is, therefore, not valid since the original decision in *Canelo, supra,* regarding the tax benefit rule has been overturned. The taxpayer may not exclude from income any recoveries of amounts for which a tax benefit was received. This is true even if the deduction was taken in a year which is barred by statute and recovered in an open year.

This issue should be raised if the amount of client costs being deducted is material. However, the adjustment is to be treated as a Category B change in accounting method under *IRC section 481* and *Rev. Proc. 92-20.*

The *IRC section 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. This computation prevents the change from resulting in the duplication or omission of items of income or deduction in subsequent years. The figure needed is the total amount outstanding for client costs receivable at the beginning of the year of change.

Since the inclusion of the *IRC section 481(a)* adjustment in income for the year of change might result in the telescoping of income for several years into one taxable year, two alternative limitations on the tax for the year of the change are allowed to be used where such adjustments increase taxable income by more than $ 3,000. They are the 3-year spread back rule and the specific allocation rule:

1. Under the 3-year rule, the net adjustment is to be allocated ratably over a 3-year period, including the taxable year of change and the 2 preceding years (*IRC section 481(b)(1)*). The increase in tax for the year of change due to the IRC section 481(a) adjustment is then limited to the sum of the increases for those 3 years resulting from the allocation of one-third of the adjustment to each year.
2. Under the specific allocation rule of *IRC section 481(b)(2)*, if the taxpayer can establish taxable income under the new method of accounting for one or more years consecutively preceding the year of change, then the increase in tax is limited to the net increase in taxes that would result from the inclusion of the adjustments in the preceding years.

In addition to the *IRC section 481(a)* adjustment, the current year adjustment (*IRC section 446*), must be calculated. This is the amount which is attributable solely to the year under audit, and as such, is adjusted entirely in the audit year. To calculate this amount, the outstanding balance of accounts receivable for client costs and advances must be determined at the end of the year of change. The difference between the *IRC section 481(a)* amount (beginning of year receivables) and the end of the year balance is the current year adjustment.

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 are followed for this issue.

Computing the Adjustment

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 and require some creativity on the part of the agent. 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.

The year of change will be determined by whether the taxpayer files a Form 3115 with the National Office requesting a change to the proper method within 90 days of being contacted for examination. See section 6.02 of *Rev. Proc. 92-20* for complete explanation. If the attorney files a Form 3115 within the 90 day period, the change will be considered initiated by the attorney and

not the Service. In such cases, the year of change will be the current year for which the Form 3115 is considered timely and no audit adjustment will be made. Also, there will be no spread of the positive *IRC section 481(a)* adjustment. If the attorney does not file a Form 3115, the year of change is the taxpayer's earliest open year. That means that if the years 1988, 1989, and 1990 are under examination, 1988 is treated as the year of change. Under certain circumstance, the examiner may designate a later year as the year of change. 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. If the change in accounting method is made by the examiner, there is no forward spread allowed for the *IRC section 481(a)* adjustment.

Figure 4-1, which follows this discussion, presents an example of how to use these figures to arrive at the adjustments assuming the year of change is 1990:

Outstanding client costs and advances:

at 1-1-90 = $ 65,000

at 12-31-90 = $ 85,000

The *IRC section 481(a)* adjustment is $ 65,000 and accounts for all clients costs deducted in prior years but not recovered. The *IRC section 446* adjustment is $ 20,000, the difference between the beginning and ending balances. This amount is attributable entirely to the 1990 year.

Exhibit 4-2 is used to compute the current year adjustment. This workpaper should be used only if the audit involves the first year that the attorney was in practice. This schedule makes no provision for picking up the prior year adjustment. It also makes no allowance for adjusting any portion of the *IRC section 481(a)* adjustment which is included in income in the current year.

FIGURE 4-1
UNRECOVERED ADVANCED CLIENT COSTS WORKSHEET

	Balance at 1-1-90	Costs Incurred in 1990	Costs Recovered in 1990	Balance at 12-31-90
Client A	8,000 (3)	2,000 (2)	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 (5)	30,000 (1)	10,000 (4)	85,000

For the Year 1990 the Tax Return
Shows a Deduction for 30,000 (1)

Costs Incurred and Recovered in

Current Year	2,000 (2)	
Costs Incurred in Prior Years and Recovered in 1990	8,000 (3)	
Total Costs Recovered During 1990 and Included in Income	(10,000) (4)	
Current Year Adjustment (Section 446)		20,000
Note: This may be calculated as the difference between the beginning of year and end of year balances.		
Prior Year Adjustment (Section 481(a))		65,000 (5)

At January 1, 1991, 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.

EMPLOYMENT TAX ISSUES

Package audit requirements necessitate an inspection of Forms W- 2 and 1099 plus consideration of potential employment tax issues. The legal profession is no different from any other type of business in regard to employee and independent contractor issues. The 20 common-law factors contained in *Revenue Ruling 87-41, 1987-1 C.B. 296* provide guidance to determine whether a provider of services is treated as an employee or as an independent contractor. The importance of each factor varies depending on the occupation and the factual context of individual cases. A check sheet which lists the common law factors is located at Exhibit 4-3. Issues specific to attorneys will be addressed since agents should already be aware of the general employment tax procedures.

An employment tax issue exists 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 complete much of the 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.

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.

The determination is more difficult when other attorneys provide the services. The right to control is an important consideration. In limited situations, other attorneys may be properly treated as independent contractors and should be issued a Form 1099. This is particularly true if the attorney's services are offered to the general public or other law firms. Close scrutiny should be given in cases where both Forms W-2 and 1099 are issued to the same party.

If it is determined that the workers should be treated as employees, the attorney/employer may raise an argument under section 530 of the Revenue Act of 1978. Under *section 530,* workers cannot be reclassified as employees for purposes of the employer's federal employment tax obligation, if the employer had a "reasonable basis" for not treating the workers as employees. See *Rev. Proc. 85-18, 1985-1 C.B. 518,* for guidance in implementing the provisions of *section 530*.

For an employer to be eligible for relief under *section 530,* (1) all Federal tax returns (including information returns) required to be filed by the employer with respect to the individual for the period were filed on a basis consistent with the worker not being an employee ("reporting consistency rule") and (2) the employer (and any predecessor) has not treated any individual holding a substantially similar position as an employee, for employment tax purposes, for periods after December 31, 1977 ("substantive consistency rule").

If it is determined that the employer is eligible for *section 530* relief, it then must be determined whether the employer had a reasonable basis for not treating the workers as employees. Section 530, of the Revenue Act of 1978, provides three safe havens that show a "reasonable basis" for not treating a worker as an employee. These are if the employer reasonably relies on (a) judicial precedent, published rulings, or a technical advice memorandum, or a letter ruling with respect to the employer; (b) prior Service audit of the employer in which employment tax deficiencies were not assessed for amounts paid to workers holding positions substantially similar to that held by the worker in question; or (c) long-standing recognized practice of a significant segment of the industry in which the worker was engaged. In addition to these safe havens, an employer may demonstrate some other reasonable basis for not treating the worker as an employee.

While section 530, of the Revenue Act of 1978, if it applies, will relieve the employer of employment tax burdens, it does not convert a worker from the status of common-law employee to the status of independent contractor. Thus, the worker is an employee for all other Code provisions. If a worker is reclassified as an employee, the attorney must treat the worker as an employee for purposes of determining whether the attorney's pension or profit sharing plan satisfies *IRC section 401(a)*'s qualification requirements, that is, the nondiscrimination, minimum participation, and minimum coverage requirements. This could potentially result in the disqualification of the employer's qualified plan status and would affect any deductions taken under the plan. Conversely, such a reclassified employee cannot maintain his or her own pension or profit sharing plan as an independent contractor.

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

Another potential audit issue exists where Forms 1099 are not issued to independent contractors after the funds have been paid 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 because *IRC section 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. This places the reporting responsibility upon the attorney who made the payments.

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.

The examiner needs to be aware that the potential for employment tax and self-employment tax issues exist with the legal profession just as with other types of businesses.

RELATED ENTITIES/TAXPAYERS

Corporate Taxpayers

Many times the agent will find that the income of a personal service corporation will be 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.

Cases have also been found where the shareholders have personally deducted travel and entertainment expenses that were entirely paid for by the corporation through corporate credit cards. The corporation had also deducted the credit card payments as travel expense. Adjustments were made to the shareholder's return for the expenses claimed. Additionally, it was determined that a large portion of the travel expense paid by the corporation was personal in nature and thus, a dividend to the shareholder.

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 section 62(c)* or *Treas. Reg. section 1.62-2(c),* or in cases where the arrangement does meet the requirements of *IRC section 62(c)* but the employee does not substantiate the expenses or return amounts in excess of the substantiated expenses within a reasonable period of time. In these cases the advance would be properly treated as wages on Form W-2.

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 corporation may simply stop filing tax returns.

There may be *IRC section 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 is not being clearly reflected, it may be necessary to determine a more equitable allocation of these items.

Corporate and Individuals

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.

Close scrutiny should be given to all funds entering and leaving the trust accounts. Abuses by clients have been uncovered during audits which resulted in adjustments to the clients' tax returns. Such abuses 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 avenues.

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 scheme resulted in a $ 100,000 deduction for the client and no declared taxable income to the attorney.

Another case involved the audit of a doctor. The doctor 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, the funds were funneled into an S-Corporation which was using them to construct a vacation home for the doctor.

ACCOUNTING PERIODS AND TAX COMPUTATIONS

The tax year of a personal service corporation must be a calendar year unless the corporation makes the election under *IRC section 444(a)* or can satisfy the Commissioner that there is a business purpose for having a different tax year. *IRC section 441(i)(1).*

In defining a personal service corporation, *Treas. Reg. section 1.441-4T(g)(1)* states that personal services are substantially performed during the testing period (1988 is the testing year for 1989 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.

An entity may elect a fiscal tax year by filing a Form 8716 with the IRS Service Center by the earlier of:

(1) the 15th day of the 6th month of the tax year for which

the election will first be effective, or

(2) the due date (without regard to extensions) of the

income tax return resulting from the fiscal tax year election.

Treas. Reg. section 1.444-3T(b)(1).

The tax returns of attorneys are generally filed 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 has control, such as retainers, will be considered income in the year of receipt (see "Gross Income").

A qualified personal service corporation is taxed at a flat 34 percent rate on its taxable income for tax years beginning after December 31, 1987. For this purpose, a qualified personal service corporation is defined in *I.R.C. section 448(d)(2).*

EXHIBIT 4-1

CLIENT COSTS AND ADVANCES

Mertens Law of Federal Income Taxation (25.28) states, "Although loans frequently represent necessary incidents to the carrying on of a trade or a business, they do not constitute deductible expenses of the lender, inasmuch as they are conditioned upon repayment and do not constitute the current cost of operating the business." Thus costs advanced by an attorney are not deductible by him as business expenses.

According to the RIA Federal Tax Coordinator, "A bad debt deduction will be allowed to an attorney for unreimbursed advances on behalf of his clients where the requisites for a bad debt deduction are met."

The following court cases support this position:

-- *Henry F. Cochrane v. Commissioner, 23 B.T.A. 202 (1931)*

-- Thomas Hart Fisher, T.C. Memo Op Dkt 5438 (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)*

-- *John J. Watts v. Commissioner, 27 T.C.M. (CCH) 886 (1968)*

-- *Adolph B. Canelo, III v. Commissioner, 53 T.C. 217 (1969)* aff'd, 446 F.2d (9th Cir. 1971)

-- *John W. Herrick v. Commissioner, 63 T.C. 562 (1975)*

-- *Ronald R. Silverton v. Commissioner, 36 T.C.M. (CCH) 817* (1977), aff'd, *647 F.2d 172 (9th Cir. 1981)*

-- *James F. Boccardo v. United States, 87-1 U.S.T.C., 9288* (1987)

-- Milan, Miller, Berger, Brody and Miller, P.C. v. United *States, 88-1 U.S.T.C., 9209 (1988)*

EXHIBIT 4-2

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

CLIENT COSTS/ADVANCES 1990

DATE 1990	CLIENT	YEAR 1990 COSTS	CASE CLOSED	COSTS RECOVERED	COSTS OUTSTANDING
1-15	Alpine, L.	1,000	1990	1,000	-0-
1-30	Boulder, S.	500	1990	500	-0-
2-13	Crockett, A.	3,000	1990	3,000	-0-
4-19	Douglas, P.	1,500	1991	-0-	1,500
5-11	Evans, J.	400	1990	400	-0-

5-24	Fisher, S.	4,500	1991	-0-	4,500
6-20	Grant, C.	2,000	1990 *	-0-	-0-
8-05	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
	TOTALS	16,900 (1)		4,900 (2)	10,000 (4)

* Case was lost and costs absorbed by attorney 2,000 (3)

Calculate the adjustment based on the formula:

Current year costs	16,900 (1)
Less: Current year costs recovered	(4,900) (2)
Current year costs unrecoverable	(2,000) (3)
Adjustment	10,000 (4)

(2) Make sure these costs have been included in income.

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.

EXHIBIT 4-3

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

20 COMMON-LAW FACTORS/REV RUL 87-41	YES/NO	IC	E/E
1. INSTRUCTIONS re when, where, and how to work			
2. TRAINING by persons hiring			
3. INTEGRATION of worker's services into business			
4. SERVICES RENDERED PERSONALLY by worker			
5. HIRING, SUPERVISING, & PAYING ASSISTANTS by employer			
6. CONTINUING RELATIONSHIP between worker and			

hirer (even recurring but irregular) _____ ____ _____

7. SET HOURS OF WORK by hirer _____ ____ _____

8. FULL TIME REQUIRED by hirer (restricts worker from doing other gainful work) _____ ____ _____

9. WORKING ON EMPLOYER'S PREMISES -- especially if work could be done elsewhere _____ ____ _____

10. ORDER OR SEQUENCE SET BY EMPLOYER (or right to do so retained by employer) _____ ____ _____

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 _____ ____ _____

16. REALIZATION OF PROFIT OR LOSS by worker (is worker subject to real risk of economic loss) _____ ____ _____

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 _____ ____ _____

********** End of Document **********