Private Letter Ruling 9432002

March 30, 1994

ISSUE

In what year certain expenses paid or incurred by a law firm on behalf of its clients are deductible under §162(a) of the Internal Revenue Code.

FACTS

The taxpayer (hereafter referred to as X) is a professional corporation engaged in the practice of law. X is on the cash receipts and disbursements method of accounting. X makes payments to third parties on behalf of specific clients for such items as court filing fees, expert witness fees, and charges for photocopying and printing done by outside firms. X pays for these items by writing checks directly to the third parties. X bills its clients for the actual amount of these out-of-pocket expenses. X claims a deduction at the time it makes these payments, and records income when the clients reimburse it for these expenses.

X also makes charges to its clients for various support-type services, such as word processing, on-line legal research, and in-house photocopying. X determines the amount of its service charges by considering such factors as the cost to X of providing the service, what similar size law firms charge [*2] for the same service and, in particular, what certain clients are considered to be willing to pay for the service. For example, X represents that it may charge different clients 20 cents, 15 cents, or 10 cents per page for in-house photocopying.

X records both its out-of-pocket expenses on behalf of a specific client, and its service charges to that client, in the client's Work In Progress (WIP) account. The service charges are also recorded in the client's Disbursement Accounts Receivable (Disbursement A/R) account. X then prepares the bill to be sent to the client.

In a telephone conference held on February 4, 1994, and in supplemental information dated February 22, 1994, X represented that it does not bill a client for certain expenses that were incurred for the client. X lists several situations in which this may occur:

(1) The client may have received an insufficient benefit for the out-of-pocket expense incurred.

(2) The amount may be so small in relation to the total billings to the client that the attorney chooses to write off the out-of-pocket expense.

(3) The out-of-pocket expense may not be recorded in WIP until after the billing attorney has already billed the client for the [*3] related legal services.

(4) The attorney may have already billed the total fees and costs quoted for the representation and not be entitled to bill the amount.

(5) The out-of-pocket expenses may be for a client that has terminated the relationship with the law firm.

The out-of-pocket expenses that X does not bill to the client are written off from the client's WIP account. X contends that it is entitled to a deduction under §162(a) in the year in which such unbilled expenses are written off of its books.

If X bills the client but is unable to obtain reimbursement, the amount not collected is written off of its books. X contends that it is entitled to a bad debt deduction under §166(a) in the year in which such expenses are written off.

LAW AND ANALYSIS

Out-of-Pocket Expenses

Section 162(a) provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 166(a) provides that there shall be allowed as a deduction any debt which becomes worthless within the taxable year.

Section 1.166-2(b) of the Income Tax Regulations provides that where the surrounding circumstances indicate [*4] that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgement, a showing of these facts will be sufficient evidence of the worthlessness of the debt for purposes of the deduction under §166.

Expenses incurred by an attorney on behalf of a client are not deductible if the attorney expects to be reimbursed, even if the reimbursement is contingent upon the success of the case. Boccardo v. United States, 12 Ct.Cl. 184, 186 (1987); Herrick v. Commissioner, 63 T.C. 562 (1975); Canelo v. Commissioner, 53 T.C. 217 (1969), aff'd, 447 F.2d 484 (9th Cir. 1971); Silverton v. Commissioner, T.C.M. 1977-198, aff'd, 647 F.2d 172 (9th Cir. 1981). This is because expenditures or advances made under an agreement that the taxpayer will be reimbursed therefor by another are in the nature of loans to that person. Boccardo at 186; See also Electric Tachometer Corp. v. Commissioner, 37 T.C. 158 (1961) (reimbursed corporate expenses held nondeductible loans).

In Canelo, the taxpayer advanced the costs of litigation to its clients under contingent-fee contracts. The law firm carefully screened its clients [*5] and only took cases when it had "good hopes" of recovery. The Tax Court noted that,

Here petitioners have made expenditures on behalf of a particular client, under a reimbursement agreement signed by the client, to pursue a claim held by the client--a claim of no use to any person other than the client. In reality, they are the client's expenditures." Id. at 225.

The court therefore held that the client advances were intended to, and did, operate as loans, rather than expenses under §162(a)." Id. at 224.

The court in Canelo also held that under the contingent-fee contract the unconditional obligation to pay a fixed sum does not arise until the case is closed. Thus, with respect to cases pending at the end of a particular year, there was no obligation to repay and, therefore, no debt that could be ascertained to be worthless at that time. However, when pending cases are closed without recovery of deferred advances, then deductions for unrecovered and lost advances are allowable. Id. at 226; Accord Hodges v. Commissioner, T.C.M. 1993-316.

The foregoing authorities show that X is not entitled to a §162(a) deduction for an expense if, as of the end of the taxable year in question, it has [*6] a claim for reimbursement of the expense. If X bills an expense but does not collect it, it may deduct the amount of the expense as a bad debt under §166(a) in such year as it can make the showing of worthlessness required by §1.166-2(b) of the regulations.

In some instances, however, X refrained, for various business reasons, from billing a client for out-of-pocket expenses incurred on the client's behalf. In such a case the requirements for a bad debt deduction would not be met. See Jostens. Inc. v. Commissioner, T.C.M. 1989-656, where the taxpayer, a manufacturer of high school and college class rings, often did not attempt to collect finance charges on customers' past due accounts. The taxpayer relied on repeat business and believed it would not be good business practice to press for the charges. The taxpayer sought a bad debt deduction under §166(a) for the cancelled finance charges. The Tax Court did not question the taxpayer's business judgment, but denied the deduction because the taxpayer had failed to demonstrate that the cancelled debts were worthless.

X contends, however, that in cases where it decides, for business reasons, to refrain from collecting an expense reimbursement [*7] from a solvent client, it is entitled to a §162(a) deduction for the expense. In effect, X seeks to deduct the expenses of its clients, which it paid.

In general, the payment by one taxpayer of the obligation of another taxpayer is not considered an "ordinary and necessary" expense for purposes of §162(a). Reading v. Commissioner, 132 F.2d 306, 311 (3rd Cir. 1942); Dunmire v. Commissioner, T.C.M. 1981-372. However, an exception to this rule arises in the situation where a taxpayer expends such funds in order to protect or promote his own established business. Lohrke v. Commissioner, 48 T.C. 679, 688 (1967); Rushing v. Commissioner, 58 T.C. 996, 1003 (1972); H. Kalicak Construction Co. v. Commissioner, T.C.M. 1984-552. Accordingly, X would appear to be entitled to deduct an expense incurred for a client if it decides for valid business reasons not to seek reimbursement from the client.

Service Charges

In contrast to X's out-of-pocket expenditures on behalf of specific clients, there is no direct correlation between its service charges and the actual costs incurred by X in rendering the services. X's expenses for services such as word processing are incurred in the context of X's general [*8] operations as a law firm. X's charges for such services are based on factors in addition to cost, such as what a competing law firm may charge for similar services.

CONCLUSIONS

We conclude as follows:

X's out-of-pocket expenditures to third parties on behalf of specific clients that are reimbursable by the clients are advances in the nature of loans. They are not deductible under §162(a) when incurred.

Because the foregoing out-of-pocket expenditures were not deductible as ordinary and necessary business expenses incurred during the taxable year in which they were incurred, X will not be in receipt of income in the year the advances are reimbursed by the client.

In those situations in which X bills a client for out-of-pocket expenses but is not paid, X will be entitled to a bad debt deduction under §166(a) in the year in which X can make the showing required by §1.166-2(b).

If X decides, for valid business reasons, not to bill a client for an out-of-pocket expense, X will be entitled to a deduction for the expense under §162(a) for the year in which it makes the final determination not to bill the client.

X will be considered to be in receipt of income in the year in which service charges [*9] are paid by a client. X's costs of providing the services for which the charges are made are deductible under §162(a) or other applicable provision of the Code in the year in which appropriate under the governing provision.

A copy of this technical advice is to be given to the taxpayer. Section 6110(j)(3) provides that it may not be used or cited as precedent.