Watching Out For Tax Authorities:

Top Three Mistakes Law Firms Must Avoid

By Jenny Chen

TAX AUTHORITIES HAVE increased their scrutiny of law firm accounting and tax practices. This article discusses the most prominent issues faced by firms, namely correct recording of advanced client costs, recognition of income from client trust accounts, and proper issuance of Form 1099. It is important for law firms and firm administrators to pay close attention to these areas, as the implications and, in some cases, penalties can be significant. Fortunately, with careful planning, these pitfalls can be avoided.

Advanced Client Costs

Authorities have recognized that law firms often incorrectly record advanced client costs, (i.e., court fees and expert testimony). Firms commonly pay these hard costs on behalf of a client and later recover them through settlement or subsequent reimbursement from the client; however, firms that report on a cash or modified cash basis of accounting may erroneously deduct these expenses when paid, and include recovered costs as income when payment is received.

The Tax Court has held that litigation cost advances that are subject to reimbursement should be treated as nondeductible loans and are therefore not deductible as ordinary and necessary expenses. Deducting these costs when paid and recognizing the reimbursement as income when received causes a distortion of income as it may take years to recover costs or obtain reimbursement from clients. This distortion of income is a concern to tax authorities as it potentially represents an understatement of income.

Part of the confusion lies in the distinction between hard and soft costs, which have different accounting and tax treatment under cash or modified cash basis of accounting. Soft costs, which are general office expenses (i.e., photocopying, research subscriptions, secretarial costs, etc.) that would be incurred even if not charged to a particular client, are different in that a current year deduction for client-reimbursed costs is allowed and any subsequent reimbursement from the client would be treated as income in the year of reimbursement.

Tax authorities will first determine whether outstanding client costs advanced are material and, if so, will then require the firm to recognize the entire amount of these costs as income in the earliest taxable year under examination. This may result in a significant increase in the amount of taxes due and additional penalties.

For example, assume the outstanding billed and unbilled client hard costs advanced are $200,000 at January 1, 2014 and $300,000 at December 31, 2014.

If the law firm is a California partnership, the $300,000 additional income will need to be allocated and taxed on each partner's individual returns. For a firm operating as a

California corporation, the $300,000 additional income will result in additional federal and state taxes of $105,000 and $26,520, plus penalties and interest, respectively. An unanticipated tax liability of $131,520 plus penalties and interest would create cash flow issues for many law firms.

To avoid this increased tax liability, law firms that have not properly recorded their hard costs advanced should consider filing Form 3115, Application for Change in Accounting Method. By filing Form 3115, law firms are allowed to spread the tax liability over a four year period. In many cases, with proper year-end tax planning and by filing Form 3115, law firms can correct this issue and potentially eliminate the tax liability.

Client Trust Accounts

Tax authorities are concerned with the understatement of income related to client trust account activities. Frequently, law firms deposit settlement proceeds into client trust accounts and then distribute the proceeds to the client (less fees earned by the law firm). Since the lawsuit is finalized and the firm's portion of fees is determinable and available, the law firm must recognize the amount as income. To discourage law firms from deferring income recognition, authorities will review the source of the funds remaining in the trust account at year end and reconcile trust account activities to the firm's other bank accounts.

To identify potential diversion and omission of income, authorities will now review both the tax filings of law firm partners (or shareholders) and their firms. Firms should expect requests for copies of endorsements on checks written to or on behalf of the law firm from trust accounts to verify that fees earned are properly deposited into the firm's general bank account and not to attorney personal accounts.

Proper Issuance of Form 1099

Generally, 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 Form 1099. But law firms often overlook the need to issue Forms 1099 to independent contractors for payments made to contractors out of client trust accounts. Law firms frequently select and hire independent contractors (i.e., expert witnesses and private investigators) on behalf of their clients, provide instructions to and monitor such contractors, and negotiate and pay the contractors for their services. Under the circumstances in which a firm is exercising such oversight or performing management functions, tax authorities may consider the firm to be a “middleman payer” that is responsible for reporting payments to contractors on Forms 1099. To ensure the proper filing of Form 1099, tax authorities are now cross referencing the copies of Forms 1099 provided by the law firm against their own record.

Another area that commonly causes confusion relates to issuance of Form 1099 for payments to recipients of lawsuit settlements. Law firms should keep in mind that the following types of damages are specifically exempt from taxation. Reporting on Form 1099 as it relates to the excluded portion of the settlement proceeds is not required:

- Compensatory damages received in connection with physical injury or physical sickness
- Damages for emotional distress on account of physical injuries or sickness (however, costs incurred to treat emotional distress, even those due to physical injury, are taxable if they were previously deducted as a medical expense in a prior year)
- Out-of-pocket medical expenses in non-physical injury settlements (i.e., discrimination, fraud and so on) incurred to treat emotional distress that were not previously deducted as medical expenses

Punitive damages, on the other hand, are not excluded from taxation, regardless of whether received in connection with a physical or non-physical injury.

To ensure that all taxable lawsuit settlements are properly reported, tax authorities scrutinize the allocation of settlement proceeds between compensatory versus punitive damages. They also determine if any portion of the settlement proceeds are designated as reportable interest income.

Due to the number of parties involved in a lawsuit, the circumstances under which firms are required to file Form 1099 as it relates to the settlement proceeds can be confusing. Below are various common scenarios and the corresponding Form 1099 requirement:

Settlement Checks to Joint or Multiple Payees

If more than one attorney is listed as a payee on the check and the check is delivered to payee attorney, the payer must file Form 1099 with respect to the payee attorney to whom the check is delivered.

As an example, plaintiff P sues defendant D for emotional distress from non-physical injuries and is represented by attorney A. D settles the suit for $300,000, writes a settlement check payable jointly to P and A in the amount of $300,000, and delivers the check to A. A retains $100,000 of the payment as compensation for legal services and disburses the remaining $200,000 to P. D must file Form 1099 with respect to both A and P in the amount of $300,000 each.

Attorney Making Payments to Other Attorneys

If payer is required to file Form 1099 with respect to a payee attorney (the tier-one attorney), the tier-one attorney must file Form 1099 for any payment that he or she makes to other unrelated payee attorneys with respect to that check. As an example, defendant D makes a payment of the gross proceeds of the taxable amount awarded under the suit to the plaintiff's attorneys A, B and C, who are not related parties. The payment is delivered to B's office. B deposits the monies into the trust account and pays A and C their respective shares. D must file a Form 1099 for the payment to B and B in turn must file Form 1099s for the payments to A and C. D also would need to report 100% of the settlement with respect to the plaintiff.

To simplify the information reporting process, many law firms may consider requesting separate checks from the payer. The advantage of having separate checks is that the law firm will receive a Form 1099 only for its fee even though the client will receive a Form 1099 representing 100 percent of the settlement. As an example, plaintiff P, who is represented by attorney A, sued for lost profits against defendant D. D settles the suit for $300,000, all of which will be includible in P's gross income. A requests D to write two checks, one payable to A in the amount of $100,000 as compensation for legal services and the other payable to P in the amount of $200,000. D writes the checks in accordance with A's instructions and delivers both checks to A. D must file Form 1099 for A and P in the amount of $100,000 and $300,000, respectively.

Due to the complexities of Form 1099 reporting requirements, all law firms, regardless of size and type of legal practice, should consider reexamining their 1099 reporting practices.

Additional Issues

Firm leadership and administrators should also be mindful of unreported income from non-cash payments to firms (i.e., partnership interest, stock, and bartering of services); gross income and proper income recognition of retainers; business and disguised hobby expenses; and proper classification of employees and independent contractors.

Careful review the firm's procedures will help avoid mistakes in the common areas listed above and miss the scrutiny of tax authorities.

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