

## IRS Audits of Attorneys' Tax Returns

**IN LIGHT OF THE MARCH 2011 RELEASE** of a revised Attorneys Audit Technique Guide to assist revenue agents who audit lawyers and law firms, the legal profession may be facing increased scrutiny by the IRS.<sup>1</sup> Audit techniques guides are produced by the IRS to provide industry-specific guidance to IRS revenue agents.<sup>2</sup> The Attorneys Audit Technique Guide provides background information about the legal profession, identifies issues unique to the industry of which the revenue agents should be aware, and sets forth specific techniques that the revenue agents should follow in conducting audits of attorneys.

The release of the revised audit guide was followed in October 2011 by news that a prominent law firm partner was being charged with making and subscribing false personal income tax returns.<sup>3</sup> On November 2, 2011, Leslie Jacobs, then a senior partner in the competition, antitrust, and white-collar crime group at Thompson Hine LLP, pleaded guilty to the felony violation of Internal Revenue Code Section 7206(1)—willfully making and subscribing a false tax return.<sup>4</sup> The criminal information against Jacobs alleged that he understated his taxable income on his 2004 to 2007 returns by a total of more than \$250,000 by overstating his business expense deductions.<sup>5</sup> He was eventually sentenced to a year plus one day in prison. Business expense deductions are just one of several issues the audit guide instructs revenue agents to scrutinize when examining an attorney's return.

Audit techniques guides have been issued as part of the IRS's Examination Specialization Program.<sup>6</sup> Previously known as the Market Segment Specialization Program (MSSP), the Examination Specialization Program was established by the IRS to enhance voluntary compliance and increase the effectiveness and efficiency of revenue agents by focusing on the tax compliance of a particular industry.<sup>7</sup>

Through the Examination Specialization Program, returns involving issues, industries, and professions that are identified by the IRS as market segments needing audit attention are assigned to identified revenue agents who are trained in the area or who receive specialized research materials.<sup>8</sup> Prior to the development of the Examination Specialization Program, the IRS would group returns on the basis of income or asset levels and types of returns and assign them to revenue agents accordingly.<sup>9</sup> As a result, revenue agents would audit returns involving a wide variety of industries, each presenting unique issues. The knowledge that the revenue agent would gain auditing one return would not necessarily assist the revenue agent in conducting any future audits. With the Examination Specialization Program, returns are now sorted by market segment. The revenue agents develop an expertise in certain areas and are better able to learn the unique business practices of a particular industry. The audit technique guides also promote consistency among the treatment of taxpayers nationally.

The new audit guide revised and updated an earlier version of the MSSP Attorney Audit Techniques Guide that was first published in 1993.<sup>10</sup> The revised audit guide describes the requirements for practicing as an attorney, identifies the accounting, banking, and record-



keeping practices commonly used in the profession, outlines steps and techniques to follow in conducting an audit, and highlights issues that revenue agents should focus on in examining an attorney.

A revenue agent's focus will vary depending on an attorney's area of expertise—certain concerns are more prevalent in some practice areas than others. For example, the contingency fee arrangement common for personal injury attorneys presents some unique issues that are discussed in the audit guide.<sup>11</sup> The type of law firm entity also will affect the issues focused on by a revenue agent, with a sole proprietorship presenting tax issues that differ from a partnership or a corporation.<sup>12</sup> Attorneys should, in particular, be aware of cer-

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tain issues that the IRS has identified as common areas of attorney noncompliance and that likely will be scrutinized during an audit.

### **Unreported Income**

Revenue agents will be looking for any income received by the attorney that was not reported on the attorney's tax return. At the beginning of the audit, a revenue agent will determine the typical payment arrangements made with clients in the attorney's practice. The audit guide describes the differences among the common fee arrangements—including specific retainers, annual retainers, and contingent fees, as well as referral fees that may be received from other attorneys.<sup>13</sup>

Revenue agents will verify an attorney's reported gross income by reviewing and comparing the attorney's timekeeping and billing records, bank account information, and accounting journals and ledgers. Particular attention will be paid to withdrawals from client trust accounts.<sup>14</sup> The revenue agent will reconcile withdrawals from the client trust account with the attorney's other accounts. Each of an attorney's bank accounts, including personal accounts, will be examined by a revenue agent. Personal bank accounts will be analyzed to determine whether any fees received from clients were deposited directly into the attorney's personal account instead of into a business account.<sup>15</sup>

Another resource available to revenue agents to determine an attorney's gross income is the Financial Crimes Enforcement Network (FinCEN) information reports. Designed to help combat money laundering and other financial crimes, these reports will notify the IRS when a taxpayer conducts certain cash transactions involving more than \$10,000. The first report is the Currency Transaction Report (FinCEN Form 104), which is used by financial institutions to report deposits and withdrawals greater than \$10,000.<sup>16</sup> Another report relied on is FinCEN Form 8300 (the Report of Cash Payments Over \$10,000 Received in a Trade or Business), which must be filed by any business, including law firms, to report cash payments received in excess of \$10,000.<sup>17</sup> Other reports reviewed by revenue agents include Reports of International Transportation of Currency and Monetary Instruments (FinCEN Form 105), Currency Transaction Reports by Casinos (FinCEN Form 103), Reports of Foreign Bank and Financial Accounts (Treasury Form TD F 90-22.1), and Suspicious Activity Reports (Treasury Form TD F 90-22.47).<sup>18</sup>

The audit guide instructs revenue agents to also investigate whether an attorney had unreported noncash income.<sup>19</sup> For example, a transactional attorney who forms partner-

ships and corporations may accept an interest in the entity as payment for legal services.<sup>20</sup> The value of the interest is income to the attorney that must be reported. The audit guide also draws attention to situations in which an attorney trades legal services for other services or performs legal services to pay back a loan.<sup>21</sup>

While examining whether an attorney has any unreported income, the revenue agent will also determine whether the income is being reported in the proper year. Revenue agents will scrutinize attempts by attorneys to defer income. Most attorneys are cash basis taxpayers, which means that income must be recognized in the year it is received.<sup>22</sup> In the case of retainers and prepaid fees, the amount must be reported as income in the year received even if the services will not be performed until a later year.<sup>23</sup>

Under the doctrine of constructive receipt, a cash basis taxpayer is taxed on income when it is subject to the demand of the taxpayer and there are no substantial limitations or conditions on the right to receive it.<sup>24</sup> In an example the IRS provides, a criminal defense attorney working as a court-appointed attorney on an indigent defense panel attempted to defer income by delaying the submission of required monthly bills to the county for payment. The audit guide explains that the attorney would be considered to be in constructive receipt of the income, because the attorney only needed to submit a billing statement to receive payment for the services, the payment was subject to the demand of the taxpayer, and there were no substantial limitations or conditions on the attorney's right to receive it.<sup>25</sup>

Another income deferral method that agents will be looking for when conducting an attorney audit involves contingency fee cases in which a settlement or judgment is received and deposited into a client trust account. Because the contingency fee amount is determinable and available as soon as a client's settlement or judgment is received, although resting in a client trust account, it is includable in income in the year received.<sup>26</sup>

### **Deduction of Business Expenses**

Revenue agents will be scrutinizing whether the expenses taken on an attorney's return are deductible and properly substantiated. This is a particularly important area to be aware of in light of the recent criminal case against Jacobs, which was based on improper deductions from his law firm partnership income.<sup>27</sup>

An area that frequently presents issues in the returns of attorneys are entertainment and recreation expenses. The Internal Revenue Code provides that entertainment, amusement, and recreation expenses are not deductible unless they are "directly related to"

or "associated with" the active conduct of the taxpayer's trade or business.<sup>28</sup> To be deductible, the taxpayer must satisfy the substantiation requirements of IRC Section 274(d), and the amounts are subject to a 50 percent disallowance.<sup>29</sup>

The IRS will generally determine that entertainment expenses are not "directly related to" the active conduct of the taxpayer's business when there are "substantial distractions" at the event creating little or no possibility of engaging in the active conduct of a trade or business.<sup>30</sup> The Treasury Regulations explain that such may be the case with meetings or discussions at nightclubs, sporting events, and other essentially social gatherings.<sup>31</sup> As an example, the audit guide offers the case in which an attorney was disallowed a deduction for the cost of a party thrown at a country club that was attended by clients, because no business discussions took place at the party.<sup>32</sup>

A revenue agent will also determine whether any expenses deducted are, in fact, personal expenses and thus, not deductible. If a revenue agent determines that an expense is a hobby of the attorney instead of a business expense, such as a wine cellar at the office, the deduction will be disallowed.<sup>33</sup> Corporate credit card purchases will also be reviewed to determine whether any are personal in nature, including living expenses.<sup>34</sup> If a law firm pays an attorney's personal expenses, the amounts will be treated as either income to the attorney or as constructive dividends, in the case of shareholders of C corporations.<sup>35</sup>

### **Advanced Client Costs**

When examining deductions, revenue agents are also instructed to determine whether the attorney is deducting costs that will be reimbursed later by the client. In contingency fee cases, attorneys commonly pay the litigation expenses on behalf of their clients, with the agreement that the amounts will be recovered out of a future settlement or judgment. These amounts are referred to as advanced client costs—an issue that is particularly prevalent with personal injury attorneys, who may not recover the costs for years, if at all.<sup>36</sup>

The IRS takes the position that advanced client costs should be treated as loans to clients if an attorney expects to be reimbursed for the costs.<sup>37</sup> Some attorneys instead deduct these costs and include the amounts in income if the costs are later reimbursed. Because it can take years to resolve a case, the IRS generally disallows this method on the basis that it has the potential to distort income and requires that the amounts be treated as loans to clients.<sup>38</sup> If the costs are never reimbursed, the attorney may deduct the amounts as bad debts.<sup>39</sup>

Because of the uncertainty surrounding whether a settlement or judgment will be reached in a case, many object to this method on the ground that there is no guarantee of reimbursement. Revenue agents are advised to look at an attorney's case selection, fee advancement processes, and success rate to determine whether there is an expectation of reimbursement.<sup>40</sup>

The Ninth Circuit has drawn a distinction on this issue between "net fee" contingency contracts and "gross fee" contingency contracts.<sup>41</sup> In a net fee contract, the attorney is reimbursed for costs before the contingency fee percentage is calculated and paid from the settlement or award proceeds. In contrast, costs are not separately reimbursed with a gross fee contract—the attorney only receives the negotiated percentage of the award.<sup>42</sup> The Ninth Circuit has held that litigation costs are not client advances when the attorney has entered into a gross fee contract because, as a matter of law, the client has no obligation to repay the money expended.<sup>43</sup> The IRS's position is at odds with this precedent in the Ninth Circuit, and the IRS has announced that it will continue to challenge deductions of litigation expenses in gross contract fee cases in all other circuits.<sup>44</sup>

### Information Reporting Requirements

In addition to determining whether any adjustments should be made to an attorney's tax liability, revenue agents will also investigate whether an attorney has been filing the necessary information reports, such as Forms 1099 and 8300. Attorneys may face penalties for failing to file these forms.

An attorney is required to file a Form 1099 for any payment of at least \$600 made to another person in the course of the attorney's trade or business.<sup>45</sup> Forms 1099 must also be filed for recipients of lawsuit settlements or awards, unless the award is specifically exempt from taxation under Internal Revenue Code Section 104, which excludes from income damages received on account of personal physical injuries or physical sickness.<sup>46</sup>

The Bank Secrecy Act and Internal Revenue Code also require that a person engaged in a trade or business report to the IRS and FinCEN on Form 8300, any transactions involving more than \$10,000 in cash conducted in the course of the trade or business.<sup>47</sup> Accordingly, any attorney who receives more than \$10,000 in cash from a client at one time or in two or more related transactions must file a Form 8300. Transactions will be considered related if they occur during a 24-hour period, or if the recipient knows, or has reason to know, that the transactions are connected.<sup>48</sup> The audit guide advises revenue agents that criminal and immigration attorneys are most likely to

receive payments in cash because some of their clients may not have bank accounts.<sup>49</sup>

### Protecting the Attorney-Client Privilege during an Audit

An audit of an attorney or law firm presents the particularly sensitive issue of client confidences and the attorney-client privilege. The audit guide identifies for revenue agents the records and documents typically kept by attorneys that the agent should request and review in conducting the examination, including fee agreements and time sheets. If an attorney refuses to provide documents by invoking the attorney-client privilege, the audit guide advises that it may be necessary to issue a summons for the documents.<sup>50</sup> The attorney may then challenge the validity of the summons on the basis that the documents requested are protected by the attorney-client privilege.<sup>51</sup>

The audit guide addresses two issues that frequently come up in audits of attorneys: whether fee arrangements and client lists are protected by the attorney-client privilege. The general rule is that fee arrangements and the identity of clients do not constitute a protected communication.<sup>52</sup> However, the Ninth Circuit has recognized an exception to this rule—documents will be protected by the attorney-client privilege if disclosure of their information would be in substance a disclosure of a protected confidential communication.<sup>53</sup> Moreover, while the specific fee arrangement is not protected, any portions of an engagement letter, retainer agreement, or any other correspondence that reveals the client's motivation for creating the relationship, the nature of legal services provided, or the attorney's litigation strategy will be protected.<sup>54</sup>

Through the publicity surrounding the recent indictment of a prominent law firm partner, the IRS is hoping to deter attorneys from making the same mistakes. For attorneys, a criminal conviction may also mean being barred from practicing law—a conviction of a tax crime could cost a lawyer his or her California State Bar license.<sup>55</sup>

The Attorneys Audit Technique Guide is part of an effort by the IRS to increase voluntary compliance among attorneys. It is important for attorneys to be aware of the potential areas of vulnerability and focus on ensuring their tax filing and payment practices are in compliance with the Internal Revenue Code and regulations. ■

<sup>1</sup> INTERNAL REVENUE SERVICE, THE ATTORNEYS AUDIT TECHNIQUE GUIDE [hereinafter ATTORNEYS ATG], available at [http://www.irs.gov/pub/irs-utl/attorneys\\_atg.pdf](http://www.irs.gov/pub/irs-utl/attorneys_atg.pdf).

<sup>2</sup> Audit Techniques Guides (ATGs), IRS, <http://www.irs.gov/businesses/small/article/0,,id=108149,00.html>.

<sup>3</sup> *United States v. Leslie W. Jacobs*, 1:11-cr-00469 at Doc. No. 1 (N.D. Ohio Oct. 13, 2011).

<sup>4</sup> *Leslie W. Jacobs*, 1:11-cr-00469 at Doc. No. 12; Tom

Huddleston Jr., *Thompson Hine Senior Antitrust Partner Pleads Guilty to Tax Fraud*, AMLAW DAILY, Nov. 3, 2011, available at <http://amlawdaily.typepad.com/amlawdaily/2011/11/thompson-hine-jacobs-guilty.html>.

<sup>5</sup> *Leslie W. Jacobs*, 1:11-cr-00469 at Doc. No. 1.

<sup>6</sup> INTERNAL REVENUE SERVICE, INTERNAL REVENUE MANUAL [hereinafter IRM] 4.28.1.1.1 & 4.28.1.1.2.

<sup>7</sup> IRM 4.10.3.3.2 and 4.28.1.1.1.

<sup>8</sup> IRM 4.28.1.1.

<sup>9</sup> *Id.*

<sup>10</sup> Steven Toscher, *Do the Right Thing: Lawyer Non-Compliance with the Internal Revenue Code*, LOS ANGELES LAWYER, June 1994, at 24.

<sup>11</sup> ATTORNEYS ATG at 3.

<sup>12</sup> ATTORNEYS ATG at 4.

<sup>13</sup> ATTORNEYS ATG at 28.

<sup>14</sup> ATTORNEYS ATG at 7, 30.

<sup>15</sup> *Id.*

<sup>16</sup> ATTORNEYS ATG at 16.

<sup>17</sup> ATTORNEYS ATG at 17.

<sup>18</sup> *Id.*

<sup>19</sup> ATTORNEYS ATG at 30-31.

<sup>20</sup> ATTORNEYS ATG at 31.

<sup>21</sup> *Id.*

<sup>22</sup> Treas. Reg. §1.451-1(a).

<sup>23</sup> ATTORNEYS ATG at 28, 45.

<sup>24</sup> Treas. Reg. §1.451-2.

<sup>25</sup> ATTORNEYS ATG at 31-32.

<sup>26</sup> ATTORNEYS ATG at 30.

<sup>27</sup> *United States v. Leslie W. Jacobs*, 1:11-cr-00469 at Doc. No. 1 (N.D. Ohio Oct. 13, 2011).

<sup>28</sup> I.R.C. §274(a).

<sup>29</sup> I.R.C. §§274(a), (d), (n).

<sup>30</sup> Treas. Reg. §1.274-2(c)(7)(ii).

<sup>31</sup> Treas. Reg. §1.274-2(c)(7)(ii)(a).

<sup>32</sup> ATTORNEYS ATG at 32; *Israelson v. United States*, 367 F. Supp. 1104 (D. Md. 1973).

<sup>33</sup> ATTORNEYS ATG at 33.

<sup>34</sup> ATTORNEYS ATG at 33, 44.

<sup>35</sup> *Id.*

<sup>36</sup> ATTORNEYS ATG at 34.

<sup>37</sup> ATTORNEYS ATG at 34-35.

<sup>38</sup> ATTORNEYS ATG at 34.

<sup>39</sup> *Id.*

<sup>40</sup> ATTORNEYS ATG at 35.

<sup>41</sup> *Boccardo v. United States*, 56 F. 3d 1016 (9th Cir. 1995).

<sup>42</sup> *Id.*; ATTORNEYS ATG at 35.

<sup>43</sup> *Boccardo*, 56 F. 3d at 1018-20.

<sup>44</sup> 1997 FSA LEXIS 442.

<sup>45</sup> I.R.C. §6041.

<sup>46</sup> ATTORNEYS ATG at 43.

<sup>47</sup> I.R.C. §6050I.

<sup>48</sup> ATTORNEYS ATG at 43.

<sup>49</sup> ATTORNEYS ATG at 3.

<sup>50</sup> ATTORNEYS ATG at 10.

<sup>51</sup> *Id.* (citing *Reisman v. Caplin*, 375 U.S. 440 (1964)).

<sup>52</sup> *See In re Osterhoudt*, 722 F. 2d 591 (9th Cir. 1983); *Colton v. United States*, 306 F. 2d 633 (2nd Cir. 1962).

<sup>53</sup> *Baird v. Koerner*, 279 F. 2d 623 (9th Cir. 1960); *In re Osterhoudt*, 722 F. 2d 591.

<sup>54</sup> ATTORNEYS ATG at 10-11.

<sup>55</sup> BUS. & CORP. CODE §6101 provides that conviction of any crime involving moral turpitude constitutes a cause for disbarment or suspension. Section 6102 further provides that the Supreme Court shall "summarily disbar the attorney if the offense is a felony...and an element of the offense is the specific intent to deceive, defraud, steal, or make or suborn a false statement." BUS. & PROF. CODE §6102(c). The Rules of Procedure of the State Bar of California also provide that even if a crime does not involve moral turpitude, an attorney can be disciplined if the crime involves "other misconduct warranting discipline." R. OF PROC. OF THE STATE BAR OF CAL., tit. IV, pt. C, St. 3.4.