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HOW IRS AUDITS ATTORNEYS

By Victor Sy, CPA

IRS released a guide to its agents on how to audit attorneys. The guide provides audit techniques to issues unique to attorneys.

IRS instructs its agents to probe into the following areas:

- Unreported income,
- Deferral of income,
- Advanced client costs,
- Bartering,
- Constructive receipts, and
- Personal service corporations.

Unreported income: Generally, attorneys deposit settlement and award proceeds to their trust accounts. Settlement and award checks are usually made out to both attorney and client. After depositing the funds to their trust accounts, attorneys must distribute the proceeds. However, the attorney will draw a portion of these funds to cover their fees and case costs for fees on a contingency basis. IRS tells auditors to determine if fees were **included in income at the proper time**. Some attorneys may **cash** fee payment checks or **deposit them directly into personal or investment accounts**. Inspect endorsements on checks written to the attorney from trust accounts. Pay special attention to all checks that either are cashed or deposited into other accounts.

Deferral of income: After a case is settled, an attorney may attempt to defer earned income by allowing fees to **remain in the trust account** until the following year. Once the settlement is received, the attorney's fee is both determinable and available and therefore **should be included in income**. Analyze the source of funds remaining in the trust account at **year-end**, particularly if there is a large ending balance.

Advanced client costs: Attorneys who take cases on a contingency fee basis commonly advance litigation expenses on behalf of clients and recover the costs out of the settlement or award. These attorneys generally use a cash basis of accounting and may deduct those expenses when paid, and include the recovered costs in income when received. However, this causes a distortion of income since it can take years to resolve these cases. Courts have determined that costs paid on behalf of a client are **loans** for tax purposes and are **not** deductible as current costs. The costs are the **client's** and not the attorney's since there is an expectation of reimbursement. However, a bad debt deduction may be taken in the year that any costs are determined to be uncollectible.

Bartering: Auditors are told to verify client subsidiary ledgers that may lead to exchange of legal services for other services that do not hit the books. For example, an attorney may borrow money from a corporate client and pay it off by performing legal services. The income from legal services is not declared and no income tax is paid on it.

Constructive receipt: Income earned under the constructive receipt doctrine is an exception to the general rule that cash basis taxpayers must have actual receipt of income to be taxable. Income is constructively received if it's subject to demand and there are **no substantial limitations or conditions on the right to receive it**. For example, a criminal defense attorney acting as a public defender bills the county on a monthly basis. At the end of the year, a Form 1099 is issued to the attorney for the income that was actually paid. To defer income, the attorney may *not* bill the county for services that have been rendered. In this case, the attorney's gross income is understated.

Personal service corporations. Attorneys doing business as regular C corporations are classified as personal service corporations (PSC) and are taxed at a higher rate. They do not get to use the lower graduated rates that start at 15% and 25%; instead, they are taxed at a high flat rate of 35%. Check if entity is properly classified as PSC and if taxes are computed at the higher tax bracket. **TIP:** Elect S status to avoid the high 35% rate and enjoy *zero* federal rate at the corporate level as well as a *ridiculously low* rate of 1 ½% (instead of about 9% that apply to C corporations). Read our tax tips on S corporations at www.victorsycpa.com.

IRS agents are also instructed to look into:

- **Worker Reclassification:** Were employees misclassified as independent contractors?
- **Form 1099s:** Were Form 1099s issued to independent contractors for payments from a trust account?
- **Form 8300:** Were Form 8300s issued for receipts of cash of \$10,000 or more?