

THIS RULE IS BEING PROPOSED UNDER AN EXPEDITED RULE-MAKING PROCESS THAT WILL ELIMINATE THE NEED FOR THE AGENCY TO HOLD PUBLIC HEARINGS, PREPARE A SMALL BUSINESS ECONOMIC IMPACT STATEMENT, OR PROVIDE RESPONSES TO THE CRITERIA FOR A SIGNIFICANT LEGISLATIVE RULE. IF YOU OBJECT TO THIS USE OF THE EXPEDITED RULE-MAKING PROCESS YOU MUST EXPRESS YOUR OBJECTIONS IN WRITING BY JUNE 7, 2004.

AMENDATORY SECTION (Amending WSR 99-13-092, filed 6/14/99, effective 7/15/99)

**WAC 458-20-207 Legal, arbitration, and mediation services.**

(1) **Introduction.** This rule explains the taxability of amounts received for legal, arbitration, and mediation services.

(2) **Definitions.**

(a) "Arbitration" means the process by which the parties to a dispute submit to the hearing and judgment of an impartial person or group appointed by mutual consent or statute.

(b) "Arbitration services" means services relating to the resolution of a dispute submitted to arbitration.

(c) "Attorney" means an active member of a state Bar Association engaged in the practice of law. The term also includes a professional service corporation incorporated under chapter 18.100 RCW, a professional limited liability company formed under chapter 18.190 RCW, or a partnership, provided the ownership of these business entities are properly restricted to attorneys and organized primarily for engaging in the practice of law.

(d) "Legal services" means services relating to or concerned with the law. Such services include, but are not limited to, representation by an attorney (or other person, when permitted) in an administrative or legal proceeding, legal drafting, paralegal services, legal research services, arbitration, mediation, and court reporting services.

(e) "Mediation" means the process by which the parties to a dispute or negotiations agree to have an intermediary hear their differences and/or positions and facilitate and/or make suggestions concerning an agreement and/or the resolution of their dispute.

(3) **Business and occupation tax.** (~~Beginning July 1, 1998,~~) Gross income from legal, arbitration, or mediation services is subject to the service and other activities classification. (~~(See section 2, chapter 7, Laws of 1997.) Previously, legal, arbitration, and mediation services were taxable under the selected business service tax classification.~~)

(a) **Gross income.** The gross income of the business generally includes the amount of compensation paid for legal,

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arbitration, or mediation services and amounts attributable to providing those services (i.e., charges for tangible personal property directly used or consumed in supplying legal, arbitration, or mediation services). Reimbursed general overhead costs are generally included in the gross income of the business even though indirectly related to litigation. Any reimbursed costs (not directly related to litigation) for which the attorney assumes personal liability for payment are also included in gross income.

(b) Overhead costs. Amounts received (or, for taxpayers reporting under the accrual accounting method, accrued) to compensate for overhead costs are fully subject to tax. Such overhead costs are taxable even though they may be separately stated on the billings or expressly denominated as costs of the client. Examples of such overhead costs include, but are not limited to:

(i) Photocopy or other reproduction charges, except charges paid to the provider, or the agent of the provider, for the official or original copy of a record, or other document, provided for litigation;

(ii) Long distance telephone tolls;

(iii) Secretarial expenses;

(iv) Office rent;

(v) Office supplies;

(vi) Travel, meals and lodging;

(vii) Utilities, including facsimile telephone charges; and

(viii) Postage, unless paid for service of legal papers as a direct cost of litigation.

(c) Excluded amounts. The following amounts are excluded from gross income if complete and accurate records are maintained of these amounts((+)).

(i) Client trust accounts. The gross income of the business does not include amounts held in trust for the client.

(ii) Litigation expenses. Attorneys are bound by the rules of professional conduct. RPC 1.8(e) prohibits an attorney from financing the expenses of contemplated or pending litigation unless the client remains ultimately liable for these expenses. This means that an attorney normally acts solely as the agent for the client when financing litigation. Accordingly, amounts received from a client for the direct expenses of litigation do not constitute gross income to the attorney. Amounts received (or, for taxpayers reporting under the accrual accounting method, accrued) to compensate for the following direct litigation expenses are not included in gross income:

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- (A) Filing fees and court costs;
- (B) Process server and messenger fees;
- (C) Court reporter fees;
- (D) Expert witness fees; and
- (E) Costs of associate counsel.

A cash basis taxpayer cannot exclude or deduct amounts of unreimbursed litigation expenses. For example, an attorney advances all the litigation expenses for a contingency fee case. The case is ultimately resolved against the attorney's client and the expenses are not repaid because of the client's bankruptcy. The attorney cannot then deduct these expenses as a bad debt or otherwise exclude them against other income earned by the attorney.

(iii) Expense advances and reimbursements. Sometimes in the regular course of business an attorney may receive amounts from a client for expenses of third-party providers or other costs incurred in connection with a legal matter other than litigation. Such amounts are excluded from the business and occupation tax only if the attorney has no obligation for payment other than as agent for the client or equivalent commitment for their payment (see WAC 458-20-111, Advances and reimbursements). Generally, such amounts will be for third-party service providers (for example, accountants, appraisers, architects, artists, drafters, economists, engineers, investigators, physicians, etc.). However, these costs could also include client expenses for registration, licensing or maintenance fees, title and other insurance premiums, and escrow fees paid to third-party escrow agents. These costs are excludable only when the attorney does not have any personal liability to the third-party provider for their payment.

(iv) Records requirement. In order to support the exclusion from taxable gross income of any of the foregoing expenses, the attorney must maintain records which indicate the amount of the payment received from the client, the name of the client, the name of the person to whom the attorney has made payment, and a description of the item for which payment was made. If the foregoing expenses are incurred outside the context of litigation or contemplated litigation, the attorney must maintain records which indicate the amount of the payment received, the name of the client, and the person to whom the attorney makes payment. In addition, the attorney must provide the person to whom payment is made with written notice that:

(A) Payment is made, or will be made on behalf of a named client; and

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(B) The attorney assumes no liability for payment, other than as agent for the named client.

(d) Multiple business activities. Attorneys and other persons engaged in providing legal, arbitration, and mediation services sometimes engage in other business activities which are classified under a different tax classification (i.e., escrow services). In some circumstances, income from these other business activities will be subject to tax under a different tax classification.

(i) Independent business activities. If the other activities engaged in by the person are independent from the legal, arbitration, or mediation services provided to the client, these activities are taxed based on the tax classification that applies to each of those other activities, provided these other activities are separately accounted for and/or itemized as a separate amount in billings or invoices to the client. Failure to separately account and/or itemize for such activities will result in classification of all activities under the service and other activities classification.

(ii) Combined business activities. If the other activities are related to the legal, arbitration, or mediation services provided to the client, the primary activity provided the client in each taxable period will determine the tax classification. Generally, the activity will be considered as related when there is some interaction between the two activities to reach an ultimate goal (i.e., a law firm which provides legal advice and brokers the financing of a business arrangement). There are a number of elements which may be examined to determine whether a sufficient relationship between the multiple activities exist. Some elements considered are the timing for the selection and provision of services, the relationship between the contracting parties, the procedure used in the selection process, the dependence of the relationship between the two or more activities, the relationship of the prices between the two activities, and the means of payment selected for the activities.

(iii) Examples. The following examples identify a number of facts and then state a conclusion. These examples should be used only as a general guide. The tax status of each situation must be determined after a review of all of the facts and circumstances.

(A) A law firm has an escrow department. This escrow department is run by employees who are not attorneys (but the supervising employee is a limited practice officer who has

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experience as a certified escrow agent), has a separate phone number, separate bank account, separate trust account, separate computer system, and maintains its own accounting system. Contracts for the escrow services state that the law firm is being retained as an independent escrow agent and not to represent any person involved in the transaction. Further, the contract states that the law firm shall not offer legal advice upon the transaction. The escrow department of this law firm would be considered an independent business activity and be taxed separately under the retailing classification for escrow businesses (see WAC 458-20-156, Abstract, title insurance, and escrow business).

(B) A law firm limits its practice to real estate. It primarily provides escrow services and real estate closings. Even though this firm has chosen to limit its practice, it is the nature and the character of its activities which will determine the primary activity for each closing. When a closing includes the preparation, selection, or drafting of the deed between the purchaser and seller, drafting legal documents to obtain clear title, and/or the preparation, selection or drafting of the promissory notes, deeds of trust, mortgages, and agreements modifying these documents, it will be presumed that the primary activity performed for the client is providing these legal services.

(I) The law firm closed a real estate transaction performing all the escrow services. Except for the escrow services provided, the firm represented the buyer in the closing. Although an attorney from the firm reviewed and approved the legal documents provided by the seller, the attorney did not prepare any legal documents for the transaction. Since the firm was representing a specific client in this real estate closing, the escrow services are considered incidental to the legal services provided. Accordingly, the firm will report the income from this transaction under the service and other activities classification.

(II) The firm was engaged by both parties in a real estate transaction to handle a real estate closing. An attorney for the firm selected and prepared the earnest money escrow agreement, the purchase and sales agreement, the closing agreement, and the deeds for the transfer. Title was clear and did not require any additional drafting. The firm also entered into an escrow agreement with both parties and held in escrow the buyer's deposit and the seller's deed. Since an attorney for the law firm was required to select, analyze, and review the

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legal documents in this transaction, the escrow activity will be considered incidental. This closing is reported under the service and other activities classification for legal services.

(III) A certified escrow agency, owned by a principal qualified under APR 12 (the limited practice rule for limited practice officers), provides both escrow and the limited legal services allowed under APR 12 to its clients. The escrow company itemizes the services provided. APR 12(d) allows a limited practice officer to select, prepare and complete documents in a form previously approved by the board for use in closing a loan, extension of credit, sale or other transfer of real or personal property. The nature of this limited license prevents an escrow company using limited practice officers from ever engaging in legal services as a primary activity in a real estate closing. Accordingly, the escrow company will report the income from escrow and closings under the retail sales classification (see WAC 458-20-156, Abstract, title insurance, and escrow business).

(IV) The same facts as above, but the escrow company hires employees who are attorneys to provide the allowable limited legal services. The result is the same. Under RPC 5.4, an attorney is prohibited from sharing legal fees with a nonlawyer and, under RPC 5.5, cannot assist a person who is not a member of the Bar Association in the performance of an activity that constitutes the unauthorized practice of law, and under RPC 7.1 a lawyer cannot make false or misleading communications about the lawyer or the lawyer's services. Accordingly, an attorney hired by an escrow company would not be providing legal services to the escrow companies' clients except to the extent authorized for a limited practice officer. Since only limited legal services can be offered, the escrow company would continue to report all fees from both the escrow and closing services under the retail sales tax classification.

(4) **Retail sales tax.** Sales of tangible personal property to attorneys for use in rendering professional services are retail sales upon which the retail sales tax must be collected. Such sales include, among others, sales of office furniture and equipment, stationery, office supplies, law books, and reference materials.

(5) **Use tax.**

(a) The use tax applies upon the use of articles purchased or manufactured for use upon which retail sales tax has not been paid or collected. This includes, but is not limited to, the following:

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(i) Materials used and consumed while rendering legal, arbitration, or mediation services; and

(ii) Office supplies and office equipment purchased by the firm for its own use.

(b) The use tax also applies to all purchases of tangible personal property acquired without payment of retail sales tax and resold to clients but not separately stated from legal services rendered on the agency's billing.