

Cite as Det No. 12-0102, 32 WTD 250 (2013)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| In the Matter of the Petition For Correction of) | <u>D E T E R M I N A T I O N</u> |
| Assessment of) | |
|) | No. 12-0102 |
| ...) | |
|) | Registration No. . . . |
|) | Document No. . . . |
|) | Audit No. . . . |
|) | Docket No. . . . |

RULE 207, RULE 111; RCW 82.04.080: B&O TAX – GROSS INCOME – ADVANCES AND REIMBURSEMENTS – EXPENSES OF LITIGATION. Any court costs or litigation expenses which the attorney is prohibited from financing by RPC 1.8(e), other than as an agent for the client, is excluded from gross income. But, a lawyer’s general overhead, even if reimbursable, is not a pass-through cost because the lawyer assumes primary or secondary liability to those types of providers.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

Chartoff, A.L.J. – A law firm that specializes in personal injury litigation, which incurs litigation expenses that the client remains liable for reimbursing the law firm regardless of the outcome of the litigation, appeals the assessment of (B&O) tax on its expense reimbursements, asserting the reimbursements were excludable from gross income under WAC 458-20-207 (Rule 207). The petition is granted in part, and denied in part. We remand the assessment to Audit for possible adjustment consistent with this decision and records the taxpayer must provide.¹

ISSUE

Were reimbursements of certain expenses incurred in litigation excludable from gross income under Rule 207?

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

FINDINGS OF FACT

The taxpayer is a [Washington] law firm that represents plaintiffs in personal injury litigation. The taxpayer takes most clients on a contingency fee basis where the payment of the taxpayer's legal fees is dependent on the outcome of the litigation.

The taxpayer customarily incurs and pays charges of third-party providers and other costs in connection with client litigation matters. It is the taxpayer's practice to enter into contracts with clients confirming the client's obligation to reimburse the taxpayer for all costs and fees advanced by the Taxpayer in the course of litigation regardless of the outcome of the litigation. The taxpayer obtains reimbursement of the exact amount of these third-party fees and costs from the client.

The Attorneys' Fee Agreement states, in relevant part:

IT IS AGREED, between Client and [Taxpayer] Attorneys, as follows:

1. Client retains Attorneys to represent Client and Client's Attorneys and Counselors at Law in a claim against _____ for injuries resulting from _____ which occurred on or about the _____ day of _____.
2. Client authorizes Attorneys to take all steps deemed by Attorneys to be advisable. Client agrees to pay to Attorneys for services [a percentage] of any amounts received or recovered by Client in said matter by way of settlement, judgment, arbitration or otherwise. . . .
4. Client shall pay all costs and investigation charges. Costs include copies at \$. . . per page and faxes at \$. . . per page. Attorneys will mail monthly statements listing such charges. Client has the option of paying these costs as incurred or paying a FINANCE CHARGE on the unpaid balance.
5. Client acknowledges that if Attorneys advance any costs on behalf of the Client, the unpaid balance of such costs shall bear a FINANCE CHARGE of . . . % per month.
6. Attorneys are authorized to pay any expenses still owing out of Client's share of the recovery. Attorneys may pursue appropriate legal action for payment of unpaid balance
8. Client and Attorneys both recognize that considerable investigative work often must be done before the merits of a case can be determined. Either the Attorneys or Client may terminate this agreement at any time. Termination will not affect the Attorney's rights to be reimbursed for costs incurred on the Client's behalf. Termination shall not affect the Attorney's lien rights under Washington law or the right of Attorneys to be compensated for the services provided prior to the date of termination.

At issue in this appeal is whether the reimbursements of costs and fees are "direct expenses of litigation" which are excludable from the taxpayer's gross income under Rule 207(c)(ii).

The Audit Division of the Department of Revenue examined the taxpayer's books and records for the period January 1, 2006 through March 31, 2010 (the audit period). The Audit Division

found that during the audit period, the taxpayer had not included in gross income client reimbursements of costs and fees related to litigation. As stated in the Auditor's detail of differences and instructions to the taxpayer, the taxpayer had excluded the following cost reimbursements from gross income on the excise tax returns: delivery charges, service of documents, witness fees, expert fees, filing fees, conferences, reports, medical records, mileage and/or parking, arbitration and mediation fees, FedEx, Kinko's, travel/lodging, color copies, exhibit materials, trial materials, film/prints/developing charges, video/CD/DVD production and reproduction, legal research, medical research, newspaper publications, meals, and employee reimbursements.

The auditor determined the taxpayer's gross income from bank deposits or deposit logs. Then, the auditor reviewed the client ledgers to determine excludable client reimbursements. The auditor excluded from gross income reimbursements from the following categories: arbitration and mediation fees, court costs, expert witness fees, and deposition charges. Audit did not allow exclusion of the remaining categories of reimbursements listed above. The audit resulted in an assessment of \$. . . , which the taxpayer timely appealed.

The taxpayer argues that Audit erred by failing to allow the exclusion of reimbursements recorded in the taxpayer's books under the following categories: expert fee, conferences, independent medical exam, medical research, travel, deposition recording fees, and medical records charge. We discuss these categories in detail below. The taxpayer argues that these are direct litigation expenses which are excludable from gross income under Rule 207. The taxpayer acknowledges that it assumes responsibility to the third party service provider to pay the fee, and the taxpayer would never refer a third party to their client to obtain payment of the fee.

Expert Fees and Conferences

The categories "expert fees" includes fees paid to expert witnesses, and to other experts. Expert witnesses are experts who provide testimony at trial. The other experts are persons hired or consulted in connection with pending or contemplated litigation to help the attorneys evaluate or build a case, and who are not anticipated to testify at trial. The category "conferences" includes costs for conferences with experts to obtain information relevant to the litigation, or to prepare for deposition.

Audit determined that only reimbursements for expert witness fees were excludable as direct expenses of litigation. Audit requested source documentation in order to identify reimbursements for expert witness fees. The taxpayer refused to provide the source documentation arguing all the expenses in these categories are excludible direct expenses of litigation. As a result, the auditor treated as expert witness reimbursements only those payments that were obviously expert witness fees because they were labeled in the client ledger as court testimony, court appearance, or deposition testimony.

Medical Research

The category "medical research" includes fees paid to . . . an independent medical research consultant. She obtains medical journal articles and texts to educate the attorneys, provides

expert review of medical records, and identifies inconsistencies and problems in the medical records for the attorneys to utilize as they conduct discovery and take depositions.

Independent Medical Exam

The category “independent medical exam” includes fees paid to medical providers for an exam related to pending or contemplated litigation.

Travel Expenses

This category includes the law firm’s expenses for traveling to take depositions or to meet with experts related to litigation.

Deposition Recording fees

This category includes fees to third party providers for videotaping depositions for possible use in the trial.

Medical Records charge

This category includes fees paid to medical providers for obtaining copies of medical records to build a case and which may be used at trial.

ANALYSIS

Washington imposes the B&O tax on every person for the act or privilege of engaging in business activities in Washington. RCW 82.04.220. “[T]he legislative purpose behind the B&O tax scheme is to tax virtually all business activity in the state.” *Impecoven v. Department of Rev.*, 120 Wn.2d 357, 841 P.2d 752 (1992). The tax is measured by applying particular rates against the value of products, gross proceeds of sale, or gross income of the business, as the case may be. RCW 82.04.220.

Gross income from legal services is taxable under the service and other activities classification. RCW 82.04.290(2). WAC 458-20-207 (Rule 207). “Gross income of the business” means the value proceeding or accruing by reason of the transaction of the business engaged in, without any deduction on account of any expense whatsoever paid or accrued. RCW 82.04.080. However, certain receipts are recognized as merely reimbursements for expenses advanced for a client, and not as income, and are excludable from gross income of the business. *See, e.g.*, WAC 458-20-111 (Rule 111); WAC 458-20-207 (Rule 207).

Rule 111 allows reimbursements to be excluded from gross income only “when the customer or client alone is liable for the payment of the fees or costs and when the taxpayer making the payment has no personal liability therefore, either primarily or secondarily, other than as agent for the customer or client.” Rule 111 has been interpreted as requiring that the taxpayer prove that the advance in question was made pursuant to an agency relationship, and prove that the taxpayer's liability to pay the advance constituted solely agent liability. *Washington Imaging Services, LLC v. Dep’t of Revenue*, 171 Wn.2d 548, 561-62, 252 P.3d 885 (2011); *Rho Co. v. Dep’t of Revenue*, 113 Wn.2d 561, 782 P.2d 986 (1989); *City of Tacoma v. Wm. Rogers Co.*, 148 Wn.2d 169, 60 P.3d 79 (2002).

The Supreme Court of Washington has addressed the unique application of Rule 111 to client reimbursements to lawyers, for advances made to third party providers in *Christensen, O'Connor, Garrison & Havelka v. Dep't of Revenue*, 97 Wn.2d 764, 769, 649 P.2d 839 (1982), and *Walthew, Warner, Keefe, Arron, Costello & Thompson v. Dep't of Revenue*, 103 Wn.2d 183, 188, 691 P.2d 559 (1984). *Christensen* concerned payments made by a law firm to attorneys in another city on behalf of the client. The parties stipulated that the out of town attorneys understood they were working directly for the clients. The court held that the requirements for exclusion under Rule 111 were satisfied.

In *Walthew*, a law firm specializing in worker's compensation and personal injury cases followed a practice of signing contracts with its clients confirming the client's obligation to pay all court costs, medical, or other expenses involved in litigation. The firm customarily paid those expenses and then sought reimbursement from the clients. The court stated:

The language of Rule 111 is consistent with [RCW 82.04.290] if it is read to reflect the statute's obvious intent to tax only gross income which is "compensation for the rendition of services" (RCW 82.04.080) or "consideration . . . actually received or accrued" (RCW 82.04.090). Rule 111 excludes those reimbursements for advances which are merely pass-throughs, where the taxpayer liability, if any, to the third party provider is solely agent liability:

The words "advance" and "reimbursement" apply only when the customer or client alone is liable for the payment of the fees or costs and when the taxpayer making the payment has no personal liability therefor, either primarily or secondarily, other than as agent for the customer or client.

(Italics ours.) WAC 458-20-111.

By excluding agent liability, the rule recognizes pass-through payments of the kind involved here. Reimbursements to attorneys for costs of litigation cannot by rules of this court constitute compensation. Lawyers are bound by the Disciplinary Rules of the Code of Professional Responsibility. DR 5-103 prohibits a lawyer from financing the costs of litigation unless a client remains ultimately responsible for those costs. Thus an attorney must because of this rule act solely as agent for the client when financing litigation. Attorneys are unique in this respect. The Department's concern that other professionals will necessarily gain an exemption by our holding is misplaced.^[2]

² [As noted by the *Walthew* court, this analysis applies only to lawyers and law firms bound by the RPCs. The *Walthew* court treated the RPC's requirement that a client remain obligated to reimburse the attorney as sufficient to establish the nature of the attorney's liability to the providers of goods or services (liability "only as an agent"). This analysis does not apply in any context other than direct litigation expenses of attorneys under WAC 458-20-207.]

. . . A lawyer's general overhead costs, even though reimbursable, are not pass-through costs because the lawyer assumes either primary or secondary liability to those types of providers. Any client liability (if assumed) to general overhead providers is secondary liability. CPR DR 5-103 does not apply to overhead even if allocated separately. It applies only to those costs which directly finance the lawsuit. . . .

We affirm the trial court. Advancements made by a law firm to finance litigation involving court reporters, physicians, process servers and expert witnesses must remain the obligation of the client and at most the attorney assumes liability “only as agent” for the client. Reimbursements for such advances are, therefore, not taxable as compensation under the state’s business and occupation tax.

Walthew, 103 Wn.2d at 188 – 190.

Disciplinary Rule (DR) 5-103(B), referenced in the *Walthew* decision, was subsequently replaced by Rule of Professional Conduct (RPC) 1.8(e), which carried over the language from DR 5-103(B). RPC 1.8(e), states:

A lawyer shall not, while representing a client in connection with contemplated or pending litigation, advance or guarantee financial assistance to a client except that:

- (1) A lawyer may advance or guarantee the expenses of litigation, *including court costs, expenses of investigation, expenses of medical examination, and costs of obtaining and presenting evidence*, provided the client remains ultimately liable for such expenses; and
- (2) in matters maintained as class actions, only, repayment of expenses of litigation may be contingent on the outcome of the matter.

There is very little authority distinguishing the expenses of litigation, for which the client must remain liable, from a lawyer’s overhead.³

³ Since the purpose of the RPC 1.8(e) is to prevent Attorneys from buying clients or having too great a financial stake in the litigation, most authority on this rule concerns lawyers seeking to pay the medical expenses or other personal living expenses of the client. RPC 1.8(e), Comment 10. The ABA model rules, comment 10, explains:

Lawyers may not subsidize lawsuits or administrative proceedings brought on behalf of their clients, including making or guaranteeing loans to their clients for living expenses, because to do so would encourage clients to pursue lawsuits that might not otherwise be brought and because such assistance gives lawyers too great a financial stake in the litigation. *These dangers do not warrant a prohibition on a lawyer lending a client court costs and litigation expenses, including the expenses of medical examination and the costs of obtaining and presenting evidence, because these advances are virtually indistinguishable from contingent fees and help ensure access to the courts.* Similarly, an exception allowing lawyers representing indigent clients to pay court costs and litigation expenses regardless of whether these funds will be repaid is warranted.

(Italics ours).

Following the *Walthew* decision, the Department amended Rule 207, which discusses the taxation of attorneys. Rule 207 explains the application of Rule 111 to attorneys, in light of the court's interpretation in *Christensen* and *Walthew*.

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

- (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.

The list of deductible expenses in the rule is not exclusive. Any court costs or litigation expenses which the attorney is prohibited from financing by RPC 1.8(e), other than as an agent for the client, is excluded from gross income. *Walthew*, 103 Wn.2d at 190. But, a lawyer's general overhead, even if reimbursable, is not a pass-through cost because the lawyer assumes primary or secondary liability to those types of providers.

Rule 207(c)(iv) describes the records required to substantiate the exclusion of direct litigation expenses, as follows:

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.

Reimbursements of direct litigation expenses will be excluded from gross income only if complete and accurate records are maintained and provided to the Department upon request. Rule 207(c)(iv); WAC 458-20-254.

We now apply Rule 207 to the audit period expenses the taxpayer seeks to exclude.

Expert Fees and Conferences

The categories "expert fees" and "conferences" included fees paid to experts in connection with litigation. Rule 207(3)(c)(ii)(D) lists "expert witness fees" as an excludable direct litigation expense. We further find that fees paid to other experts who are retained in connection with pending or contemplated litigation for the purposes of evaluating and building a case, obtaining information relating to a case, or preparing for deposition are "expenses of investigation" or "costs of obtaining and presenting evidence" which a client is required to be liable for under RPC 1.8(e). We conclude these expenses are excludible direct litigation expenses to the extent the taxpayer can satisfy the records requirements in Rule 207(c)(iv).

Medical Research

The category "medical research" includes fees paid to . . . an independent medical research consultant, for medical research and analysis of medical records for purposes of contemplated or pending litigation. [The independent medical research consultant] appears to be a paralegal or lay investigator. Since the rules of professional conduct permit lawyers to employ investigators and paralegals, we conclude this is not a direct litigation expense lawyers are prohibited from

assuming by the rules of professional conduct. RPC 5.3 [Comment 1].⁴ Accordingly we conclude this expense is overhead which is not excludible from gross income as a direct litigation expense.

Independent medical exam

This category includes fees paid to medical providers for an exam related to litigation. A client must remain liable for “expenses of medical examination” under RPC 1.8(e). *Walthew*, 103 Wn. 2d at 190 (“Advancements made by a law firm to finance litigation involving . . . physicians . . . must remain the obligation of the client and at most the attorney assumes liability “only as an agent” for the client.”) We conclude that they are excludable direct litigation expenses, provided the records requirement in 207(c)(iv) is satisfied.

Travel

The category “travel” includes the law firm’s expenses for traveling to take depositions or to meet with experts related to litigation. Rule 207(3)(b)(vi) states that “Travel, meals and lodging” are overhead costs that are fully subject to tax, even though they may be separately stated on the billings or expressly denominated as costs of the client. Therefore, we conclude that these reimbursements were not excludible direct litigation costs.

Videotaping Depositions

This category includes charges to third party providers to videotape depositions for the purpose of showing the video at trial. These charges are “costs of obtaining and presenting evidence” which the client must be liable for under RPC 1.8(e). We conclude that they are excludible direct litigation expenses to the extent the taxpayer can satisfy the records requirements in Rule 207(c)(iv).

Medical Records Charge

This category includes fees paid to medical providers for searching for and duplicating medical records which may be used to build a case and as evidence at trial. Rule 207(b)(1) states that overhead includes “[p]hotocopy 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.” While photocopy charges are generally considered overhead, charges to a provider for the copy of a document provided for litigation are not. Here, the taxpayer pays fees to a medical provider for records needed for litigation. Furthermore, Rule 207(c)(ii) states that court costs are direct litigation expenses excludible from gross income. The charge for medical records may be included in court costs, when those medical records are

⁴ RPC 5.3 [Comment 1] states:

Lawyers generally employ assistants in their practice, including secretaries, investigators, law student interns, and paraprofessionals. Such assistants, whether employees or independent contractors, act for the lawyer in rendition of the lawyer’s professional services. A lawyer must give such assistants appropriate instruction and supervision concerning the ethical aspects of their employment, particularly regarding the obligation not to disclose information relating to representation of the client, and should be responsible for their work product. The measures employed in supervising nonlawyers should take account of the fact that they do not have legal training and are not subject to professional discipline.

submitted as evidence. 14A WAPRAC § 36:17. We find the medical records charges are “cost of investigation” or may involve “costs of obtaining and presenting evidence.” Accordingly, we conclude that they are excludible direct litigation expenses to the extent the taxpayer can satisfy the records requirements in Rule 207(c)(iv).

DECISION AND DISPOSITION

The taxpayer’s petition is granted in part and denied in part. Reimbursements of expert fees, conferences, independent medical exam, videotaping depositions, and medical records charge are allowable exempt direct litigation expenses, subject to records that Audit may, in its discretion, require the taxpayer to produce consistent rule 207(c)(iv) and with the decision. Reimbursements of travel expenses and medical research expenses are non-excludible overhead expenses.

Dated this 23rd day of April 2012.