TR 97/6 - Income tax: tax treatment of solicitors' disbursements/recoupments

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Taxation Ruling
Income tax: tax treatment of solicitors' disbursements/recoupments

other Rulings on this topic

TR 93/11; TD 94/45

contents para

What this Ruling is about **1**
Class of person/arrangement 1
Ruling **4**
Date of effect **7**
Explanations **10**
Disbursements 11
Recoupments 15
When are recoupments of disbursements assessable? 17
Alternative views 21
Amounts received by the solicitor on behalf of another for the payment of anticipated disbursements 24
Payment of a disbursement or recoupment of a disbursement from moneys held in trust 26
Examples **29**

This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the ***Taxation Administration Act 1953****, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

Class of person/arrangement

1. This Ruling applies to solicitors who are required, for purposes of income tax, to account for fee income on an earnings basis rather than a receipts basis. The Ruling discusses the tax treatment of disbursements incurred by solicitors in respect of which recoupment may be sought from clients. This Ruling does not apply to solicitors when they are merely acting as agent for their client.

2. It is not the purpose nor intent of this Ruling to define which, or when, payments are disbursements. This will, in each case, depend upon the contract between the solicitor and the third party payee who provides the goods or services for which a payment is made and any contract of engagement between the client and the solicitor.

3. It is our understanding that it is common practice for solicitors to recover some categories of expenses, such as photocopying, at a standard rate and as a separate item in the bill of costs. This Ruling does not express a view on how solicitors should record or present categories of expenses or other information in their bill of costs to clients.

Ruling

4. A solicitor who, for purposes of income tax, accounts for fee income on an earnings basis should also account for disbursements and recoupments of disbursements in the same manner.

5. Although the individual contract between the client and solicitor and the contractual relationship between the solicitor and the provider of the goods or services will in each case determine the correct tax treatment, it is our view that, as a general rule, disbursements made by solicitors in the performance of legal services, and in the normal course of their legal practice, are deductible outgoings when incurred. They are incurred when the solicitor comes under a presently existing liability to make payment either immediately or in the future.

6. It is also our view that amounts payable to the solicitor by the client, as a recoupment of such disbursements made by the solicitor, are assessable income according to ordinary concepts. Under those concepts, income will be derived when it becomes a recoverable debt due to the solicitor for which the solicitor is not obliged to take any further steps before becoming entitled to payment.

Date of effect

7. While generally this Ruling applies to years commencing both before and after its date of issue, it is recognised that the Commissioner has previously expressed a view (refer to paragraph 21) that disbursements and recoupments were considered to be in the nature of loans and therefore to be excluded from the calculation of taxable income. Although these views were contained in documents that were essentially in-house documents as discussed in Taxation Determination TD 94/45, for taxpayers who have excluded recoupments and disbursements from the calculation of their taxable income, this Ruling only applies to years commencing after its date of issue. Where in the year of changeover a recoupment is received for a disbursement, that in accordance with past practice was not claimed as a deduction, the recoupment should not be brought to account as assessable income. Also, this Ruling may not apply to taxpayers to years commencing before the date of issue of the Ruling to the extent that it conflicts with: an Advance Opinion; a Private Binding Ruling; or written advice given to the taxpayer by this Office.

8. Taxpayers may continue to rely on Private Binding Rulings given for the 1996/97 or future income years, unless the arrangement about which the Private Binding Ruling has been given has not begun to be carried out at the date of this Ruling; or the Commissioner has formed an opinion, as specified in paragraph 14ZAU(2)(b) of the *Taxation Administration Act 1953* ('TAA'), on that arrangement.

9. This Ruling also does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before

the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

10. The method of accounting to be adopted to ascertain the assessable income derived by a taxpayer is that which is calculated to give a 'substantially correct reflex of the taxpayer's true income' (*C of T (SA) v. Executor, Trustee & Agency Co of South Australia Ltd* (*Carden's* case) (1938) 63 CLR 108; (1938) 5 ATD 98). Applying this criterion, we consider it appropriate that a solicitor who accounts for income from fees relating to professional services rendered on an earnings basis should use the same basis to bring to account the recoupment of disbursements.

Disbursements

11. Disbursements are particular outgoings recognised in the legal profession as being necessarily incurred by a solicitor in performing professional services for a client. It is our understanding that disbursements describe a range of costs which are, essentially, payments made on behalf of a client for which the client is not directly liable. Typical disbursements include payments for court fees, counsel fees, fees for the registration of documents, and charges for postage, telephone calls, travel and other out of pocket expenses. Further, it is our understanding that payments for which the client is primarily liable, such as stamp duty and payments into court as security, are not disbursements.

12. It is our view that the incurring of disbursements is an ordinary and necessary incident of rendering a solicitor's professional services and that, subject to paragraph 14, disbursements are outgoings generally deductible to a solicitor under subsection 51(1) of the *Income Tax Assessment Act 1936* ('ITAA') in the year of income in which they are incurred (*Ronpibon Tin NL v. FC of T* (1949) 78 CLR 47). They are incurred when the solicitor comes under a presently existing liability to make payment, either immediately or in the future (*FC of T v. James Flood Pty Ltd* (1953) 88 CLR 492; (1953) 10 ATD 240; 5 AITR 579) (see Examples 1, 6, 7 and 8 of this Ruling).

13. Solicitors may also incur expenses that are not, strictly speaking, disbursements within the meaning of that term as it is recognised in the legal profession, but which nevertheless are incurred in the derivation of their income and which would satisfy the requirements of subsection 51(1) such as, for example, expenses incurred in performing services of a non-legal nature for a client.

14. In each case deductibility can only be determined by reference to the particular facts, and especially by reference to the terms of any contract or arrangement between the solicitor and the third party payee and the solicitor and client.

Recoupments

15. The ability of a solicitor to recover expense payments from a client may result from agreement or convention. It is our understanding that disbursements incurred by solicitors are generally recovered by being included in the bill of costs the solicitor renders to the client. In these circumstances, the payment and recoupment of disbursements is part of the normal outgoings and revenue flow of a solicitor's practice.

16. As part of the ordinary revenue flow of a solicitor's practice it is our view that amounts recouping disbursements should be treated no differently, for tax purposes, from fees for professional services rendered. Similarly, where disbursements are recouped otherwise than through the bill of costs they are considered to be assessable, in accordance with the principles in paragraph 18, at the time the entitlement arises.

When are recoupments of disbursements assessable?

17. Generally, an amount representing a recoupment of a disbursement is assessable income of a solicitor under subsection 25(1) of the ITAA in the year of income in which it is derived.

18. Taxation Ruling TR 93/11 sets out our views on when fees are derived under subsection 25(1) by professional persons, such as solicitors, whose income is assessable on an accruals or earnings basis. These views are also applicable to amounts receivable by professional persons as recoupment of disbursements. In short, the time of derivation is determined primarily by when, on a proper construction of the contract or arrangement between the professional person and the client, a recoverable debt is created (*Henderson v. FC of T* (1969-70) 119 CLR 612; 70 ATC 4016; (1970) 1 ATR 596) such that the professional person is not obliged to take any further steps before becoming entitled to payment (*FC of T v. Australian Gas Light Co* 83 ATC 4800; (1983) 15 ATR 105 (*AGL* case)). As explained in TR 93/11 at paragraphs 5 to 7 and 10, the time at which a recoverable debt is created may vary. Most commonly, this will be when the professional person has performed the work and has become entitled to bill the client. Where, in the normal course of business, a bill could be rendered in a year of income it is not accepted that a professional person can defer assessment of income simply by deliberately

refraining from billing until after the close of the income year (see Examples 1,2, 6, 7 and 8 of this Ruling).

19. It has been suggested to us that there are situations where the mere sending of a bill of costs to a client does not result in a recoverable debt being created. Examples put to us are:

- if a solicitor, in New South Wales, fails to make the necessary disclosure under section 175 of the *Legal Profession Act 1987* (NSW), the client need not pay the costs unless they have been assessed by a costs assessor;
- a solicitor's costs and disbursements are liable to be assessed by a costs assessor unless the solicitor and client have entered into a valid cost agreement;
- a solicitor cannot sue on a bill of costs for at least 30 days.

20. It has also been claimed that there are other barriers to cost recoveries under various court jurisdictions and legislation. In our view, none of the circumstances referred to has, for the solicitor's costs and disbursements, the effect of preventing a debt coming into existence before or at the time of the rendering by the solicitor of the bill of costs. These circumstances merely go to the operation of impediments upon the immediate recovery of the debt. The distinction between the coming into existence of a debt and the operation of impediments upon the recovery of an existing debt is well established and drawn in many areas of the law - see *Barratt v. FC of T* 92 ATC 4275 at 4283; (1992) 23 ATR 339 at 348 (*Barratt's* case). It is our view that even if a client invokes their right to have a bill of costs assessed, derivation is not delayed until the bill of costs is assessed.

Alternative views

21. An alternative view is that while disbursements are deductible when incurred, though not necessarily paid, recoupments for disbursements are assessable only when received. This, it has been argued, is because amounts recouping disbursements, strictly speaking, may not be in the nature of fees for services rendered. However, it is our view that recoupments of disbursements are an integral part of the total amount billable to the client as the cost of providing the legal services. They are part of the normal revenue flow of the legal practice and are assessable as income according to ordinary concepts on an earnings basis.

22. Another view, which was expressed in 1970 in Victorian Income Tax Rulings 754 and 802 and New South Wales Income Tax Circular Memorandum 860, is that disbursements made by a solicitor are not

deductible against the solicitor's assessable income and that recoupment of a disbursement does not form part of the solicitor's assessable income. However, it is our view that disbursements made by a solicitor in the ordinary course of the provision of legal services for the client are deductible for the reasons explained in paragraph 12 and, accordingly, this Ruling replaces the views expressed in those documents.

23. Of course, where a solicitor is merely acting as the client's agent and/or has made a loan to the client, the expenditure may not be deductible nor its recoupment assessable. In these circumstances, the solicitor is, in a strict sense, acting outside the scope of his or her professional appointment and, in any event, when a solicitor pays an expense for which the client is primarily liable it is not considered to be a disbursement. Whether a solicitor is merely acting as the client's agent and/or is making a loan to a client may only be concluded by an examination of the treatment of specific items and the terms of the individual contract between the client and the solicitor and the contractual relationship between the solicitor and the provider of the goods or services (see generally the comments of Hill J in *Ogilvy and Mather Pty Ltd v. FC of T* 90 ATC 4836 at 4857-8; (1990) 21 ATR 841 at 866).

Amounts received by the solicitor on behalf of another for the payment of anticipated disbursements

24. Moneys may be paid by a client to a solicitor in anticipation of disbursements to be made. It is our understanding that moneys received by a solicitor on behalf of a client for a particular purpose must be held exclusively for that client, either in a trust account or as controlled money, as that term is defined in relevant State legislation. These moneys can only be paid on the authority/direction of that client and are held by the solicitor as trustee.

25. It is our view that the receipt of moneys for anticipated disbursements by the solicitor as trustee does not involve a derivation of income by the solicitor. Such a receipt is not payment for legal services rendered by the solicitor (including the incurring of disbursements) and is not available to the solicitor for free use or dissemination. It is not income according to ordinary concepts (see Examples 3, 4 and 5 of this Ruling).

Payment of a disbursement or recoupment of a disbursement from moneys held in trust

26. Where a solicitor incurs a liability for a disbursement and immediately satisfies that liability by payment from their trust account

or from controlled moneys directly to the person to whom the liability is owed, an outgoing is incurred by the solicitor which is immediately satisfied by the direct payment to the third party creditor. In these circumstances, the solicitor's entitlement to a deduction in accordance with paragraph 12 and the derivation of income in accordance with paragraph 18 arise at the same time. This situation would occur where, for example, a solicitor filed documents in a Court registry and immediately paid the filing fee with moneys drawn from their trust account or from controlled moneys.

27. Similarly, where a disbursement is paid for by the solicitor from his/her own moneys when moneys for the disbursement are available in a trust account, the entitlement to a deduction arises when the liability for the disbursement is incurred. In such a case, it is our view that the derivation of income, in accordance with paragraph 18, occurs when the solicitor is, under the relevant legislation and the agreement between the solicitor and the client, entitled to obtain a recoupment of the disbursement from the moneys held in trust even though the solicitor may choose to delay the actual recoupment.

28. It has been suggested that derivation of recoupments from amounts in trust only occurs when the solicitor bills the client or transfers the amount from trust. However, it is our view that derivation occurs when the solicitor is entitled to recoup the moneys from the trust account. This will occur when the solicitor is, under the relevant provisions of the relevant legislation governing the solicitor's actions and the agreement between the solicitor and the client, entitled to trust moneys and trust moneys are available (see Examples 3, 4 and 5 of this Ruling).

Examples

Example 1

29. A legal firm is engaged by a client. In performing its professional services, the firm obtains counsel advice on a particular matter. Counsel bills the firm for this advice on 1/6/95. The firm also incurs other out of pocket expenses on behalf of the client prior to 1/7/95. Under the contract, the solicitor has a recoverable debt in respect of counsel fees and the other disbursements on completion of all work to be performed. The firm completes all work and bills the client on 30/7/95 for professional fees plus the disbursements comprising the counsel fees and various out of pocket expenses. The firm pays counsel's bill on 1/8/95, and the client pays the firm's bill on 30/8/95.

30. The firm is entitled to a deduction for the disbursements, both the out of pocket expenses and the counsel fees, in the year of income ended 30/6/95. The firm is assessable on the amounts receivable from the client as recoupments of the disbursements in the year of income ended 30/6/96.

Example 2

31. A legal firm bills a client on 2/6/92 for fees including disbursements. The client pays the bill on 30/7/92.

32. The firm is assessable on the full amount billed for the year ended 30/6/92 and accordingly must include this amount in their return of income for the year end 30/6/92.

Example 3

33. A legal firm is engaged by a client. A cheque for an amount is received from the client in advance of a disbursement to be paid. This cheque is placed, on 28/6/94, directly into a trust account. The legal firm is, under the relevant provisions of the relevant legislation governing the solicitor's actions and the agreement between the solicitor and the client, entitled to money in the trust account at the time of or in anticipation of the incurring of the disbursement. However, the solicitor does not, in the normal course and in accordance with the accepted practice of his/her profession, draw against cheques until they are cleared. The cheque is cleared on 4/7/94.

34. The legal firm incurs the disbursement on 29/6/94. The disbursement is subsequently paid from funds held in the trust account. Although the cheque was cleared and was available on 4/7/94, due to a delay in book work, the payment is not made until 10/7/94.

35. It is our view that the receipt of the amount and its payment into the trust account does not give rise to income assessable to the solicitor. The disbursement is deductible to the legal firm in the year ended 30/6/94. The entitlement to recoup the amount from the trust account occurs on 4/7/94; it is at this time the income, viz., the recoupment for the disbursement, is derived. The delay in payment does not delay derivation.

Example 4

36. A legal firm is engaged by a client. A cheque for an amount is received from the client in advance of a disbursement to be paid. This

cheque is placed, on 20/6/91, directly into a trust account. The legal firm is, under the relevant provisions of the relevant legislation governing the solicitor's actions and the agreement between the solicitor and the client, entitled to moneys in the trust account at the time of or in anticipation of the incurring of the disbursement. The cheque is cleared on 27/6/91.

37. The legal firm incurs the disbursement on 28/6/91. The disbursement is paid, on 2/8/91, from funds held in the trust account.

38. It is our view that the receipt of the amount and its payment into the trust account does not give rise to income assessable to the solicitor. The disbursement is deductible to the legal firm in the year ended 30/6/91. The entitlement to recoup the amount from the trust account occurs on 28/6/91; it is at this time the income, viz., the recoupment for the disbursement, is derived.

Example 5

39. A legal firm is engaged by a client. A cheque for an amount is received from the client in advance of a disbursement to be paid. This cheque is placed, on 20/3/90, directly into a trust account. The legal firm is, under the relevant provisions of the relevant legislation governing the solicitor's actions and the agreement between the solicitor and the client, entitled to moneys in the trust account at the time of or in anticipation of the incurring of the disbursement. The cheque is cleared on 27/3/90.

40. On 28/3/90 the legal firm withdraws money in anticipation of the disbursement to be incurred. The legal firm incurs the disbursement on 30/3/90 and pays the disbursement on 30/3/90 from the money withdrawn on 28/3/90.

41. It is our view that the receipt of the amount and its payment into the trust account does not give rise to income assessable to the solicitor. The disbursement is incurred by the legal firm on 30/3/90 and the entitlement to recoup the amount from the trust account occurs on 30/3/90; it is at this time the income, viz., the recoupment for the disbursement, is derived.

Example 6

42. A legal firm is engaged by a client. In performing its professional services for clients, the firm has photocopying performed by a service entity. The firm has photocopying done, for the client, by the service entity. The service entity bills the firm for the photocopying on 15/6/96 and the firm comes under a presently existing liability for the photocopying at that date. Under the contract

between the solicitor and client, the solicitor has a recoverable debt on completion of all work to be performed. The firm completes all work and bills the client on 30/7/96 for professional fees plus the disbursements.

43. It is our understanding that in the above circumstances the cost of photocopying is a disbursement. The firm is entitled to a deduction for the cost of photocopying, as billed by the service entity, for the year ended 30/6/96. The firm is assessable on the amount of the bill rendered to the client for the year ended 30/6/97.

Example 7

44. A legal firm is engaged by a client. Under the terms of engagement between the legal firm and the client, the firm is entitled to charge to the client amounts charged to it for travel.

45. In performing legal services for the client, a solicitor of the firm undertakes air travel. On 25/6/93 the legal firm purchases an airline ticket for $500. Under the terms of purchase it is the solicitor who is primarily liable for the cost of the ticket. On 27/7/93 the firm bills the client for services performed and disbursements including $500 for air travel.

46. The legal firm is entitled to a deduction for the cost of the airline ticket in the year ended 30/6/93. It is assessable on the full amount of the bill, including the recoupment of the disbursement of $500 for the airline ticket, for the year ended 30/6/94.

Example 8

47. A legal firm is engaged by a client. The client and the legal firm enter into a conditional costs agreement; this specifies that the client is not liable for costs until litigation is finalised. During the course of conducting the client's case, the legal firm sends to the client statements of account showing amounts for the which the client, on the completion of litigation, will become liable.

48. During the year ended 30/6/89, the legal firm renders statements of accounts for a total of $10,000 to the client. However, the litigation is not finalised as at 30/6/89.

49. It is our view that, for the year ended 30/6/89, according to the principles outlined in paragraph 18, the legal firm does not have a recoverable debt for the $10,000 detailed in the statements of accounts presented to the client. As the legal firm does not have a recoverable debt it has not derived the income of $10,000 for the year ended 30/6/89.

50. Of course the expenses, including disbursements, are deductible to the firm in accordance with the principles set out at paragraph 12. This is at the time when they are incurred, and this is not, generally, dependent upon when a recoverable debt has been created.

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- ITAA 25(1)
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case references
- C of T (SA) v. Executor, Trustee & Agency Co of Sth Aust Ltd (Carden's Case) (1938) 63 CLR 108; (1938) 5 ATD 98
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- FC of T v. Australian Gas Light Co 83 ATC 4800; (1983) 15 ATR 105
- Henderson v. FC of T (1969-70) 119 CLR 612; 70 ATC 4016; (1970) 1 ATR 596
- Ogilvy and Mather Pty Ltd v. FC of T 90 ATC 4836, (1990) 21 ATR 841
- Ronpibon Tin NL v. FC of T (1949) 78 CLR 47