TR 96/D16 - Income tax: tax treatment of solicitors' disbursements and recoupments

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Draft Taxation Ruling
Income tax: tax treatment of solicitors' disbursements and recoupments

other Rulings on this topic

TR 93/11; TD 94/45

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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 accruals basis rather than a cash received 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.

Ruling

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

4. It is the individual contract between the client and solicitor and the contractual relationship between the solicitor and the provider of the goods and services that will in each case determine the correct tax treatment. We believe 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.

5. 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

6. This Ruling applies to years commencing both before and after its date of issue. However, the 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. The documents referred to in paragraph 17 below and released in 1970 are not advice to a taxpayer. These documents were essentially in-house documents, as discussed in Taxation Determination TD 94/45, used by ATO officers in making decisions and, of themselves, are not considered advice to taxpayers.

7. 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

8. 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 accruals basis should use the same basis to bring to account the recoupment of disbursements.

Disbursements

9. 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.

10. We believe that the incurring of disbursements is an ordinary and necessary incident of rendering a solicitor's professional services and that, subject to paragraph 11 below, they are outgoings generally deductible to a solicitor under subsection 51(1) of the *Income Tax Assessment Act 1936* ('the Act') 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; (1953) 5 AITR 579).

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

12. 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

13. 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 that 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.

14. 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 15 below, at the time the entitlement arises.

When are recoupments of disbursements assessable?

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

16. 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 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* (1970) 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 (*FCT v. Australian Gas Light Co* 83 ATC 4800; (1983) 15 ATR 105). As explained in TR 93/11, at paragraphs 5, 6, 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 income year 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.

Alternative views

17. 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 accruals basis.

18. 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 9 of this Ruling. Accordingly, this view replaces the views expressed in those documents.

19. 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 something 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, 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* (1990) 21 ATR 841 at 866; 90 ATC 4836 at 4857-8).

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

20. 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.

21. 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.

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

22. Payment of a disbursement by a solicitor from moneys held in a trust account or from controlled moneys is an outgoing incurred by the

solicitor which has been simultaneously reimbursed. It is our view that in such circumstances the entitlement to a deduction, in accordance with paragraph 9 of this Ruling, and the derivation of income, in accordance with paragraph 15, arise at the same time.

23. 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 15 above, occurs when the solicitor is, under the relevant State legislation, 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.

Examples

Example 1

24. A legal firm is engaged by a client. In performing its professional services, the firm obtains advice from counsel on a particular matter. Counsel bills the firm for this advice on 1/6/93. The firm also incurs other out of pocket expenses on behalf of the client prior to 1/7/93. 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 30/7/93 for professional fees plus the disbursements comprising the counsel fees and various out of pocket expenses. The firm pays counsel's bill on 1/8/93, and the client pays the firm's bill on 30/8/93.

25. 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 30/6/93. The firm is assessable on the amounts receivable from the client as recoupments of the disbursements in the year of income ended 30/6/94.

Example 2

26. A legal firm bills a client on 2/6/94 for fees including disbursements. The client pays the bill on 30/7/94.

27. The firm is assessable on the full amount billed for the year ended 30/6/94 and accordingly must include this amount in their return of income for the year end 30/6/94.

Example 3

28. A legal firm is engaged by a client. An amount is received from the client in advance in anticipation of a disbursement to be paid. This amount is placed directly into a trust account. The legal firm is entitled to moneys in the trust account at the time of or in anticipation of the incurring of the disbursement. The disbursement is subsequently paid from funds held in the trust account.

29. 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.

30. The disbursement is deductible to the legal firm when incurred and the entitlement to recoup the amount from the trust account results in income being derived at the same time.

Example 4

31. A legal firm is engaged by a client. The firm has all photocopying done by a service entity. At the time of engagement an agreement is entered into whereby the client is directly liable to the service entity for photocopying. In performing its professional services, the firm has photocopying performed by the service entity. The service entity bills the client for the photocopying. The client pays the bill rendered by the service entity.

32. It is our understanding that in the above circumstances the cost of photocopying is not a disbursement. Nor is the bill rendered to the client by the service entity considered a derivation of income by the firm.

Example 5

33. A legal firm is engaged by a client. In performing its legal services for the client the legal firm photocopies documents. The legal firm charges the client for the photocopying at a standard rate of $1 per page.

34. The client is billed for services performed including photocopying. It is our understanding the charge made to the client is not a disbursement but a charge for service. In this case the amount of the bill including the charges for photocopying is assessable to the solicitor when derived and the costs associated with photocopying are expenses deductible when incurred.

Example 6

35. 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.

36. In performing legal services for the client a solicitor of the firm undertakes air travel. On 25/6/95 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 27/7/95 the firm bills the client for services performed and disbursements including $500 for air travel.

37. The legal firm is entitled to a deduction for the cost of the airline ticket in the year ended 30/6/95. 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 30/6/96

Your comments

38. If you wish to comment on this Draft Ruling please send your comments by: 31 October 1996

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- C of T (SA) v. Executor, Trustee & Agency Co of Sth Aust Ltd (1938) 63 CLR 108; (1938) 5 ATD 98
- FC of T v. James Flood Pty Ltd (1953) 88 CLR 492; (1953) 10 ATD 240; (1953) 5 AITR 579
- FCT v. Australian Gas Light Co 83 ATC 4800; (1983) 15 ATR 105
- Henderson v. FC of T (1970) 119 CLR 612; 70 ATC 4016; (1970) 1 ATR 596
- Ogilvy and Mather Pty Ltd v. FC of T (1990) 21 ATR 841; 90 ATC 4836
- Ronpibon Tin NL v. FC of T (1949) 78 CLR 47