

Lawyer Beware: Kickbacks From Deposition Firms Expose Law Firms And Lawyers To Possible I.R.S.Tax Penalties

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Booking a deposition with a licensed court reporter should not expose lawyers or law firms to possible tax problems. However, the way some court reporting firms entice business may entangle lawyers and law firms with the Internal Revenue Service as well as the Franchise Tax Board.

Most lawyers don't realize that some court reporting providers vigorously market their services to the secretaries, legal assistants, and paralegals who frequently select which court reporting provider to use. Some court reporting providers regrettably go so far as to offer kickbacks to law firm employees in exchange for bookings. These kickbacks – often entirely unknown to lawyers or law firm managing partners -- can be of significant value: cash and gift cards, spa treatments, tickets to major Broadway plays, bottles of expensive champagne, airline tickets and free condominium stays, contests with valuable prizes awarded.

While the court reporting providers style these valuables as “gifts,” both practically and as a matter of tax law they are not gifts but payments for services. As confirmed by a recent, thorough analysis by counsel at Hanson Bridgett, the law deems these valuables to be compensation paid to a lawyer's or law firm's employee in exchange for services provided; namely, giving the lawyer's or law firm's business, often exclusively, to one court reporting provider.

The valuables that raise tax issues are specifically offered as *quid pro quos*: valuable items offered and delivered in exchange for the scheduling of reporting business. Further, even if the kickback is characterized as a prize, award or as points, the Internal Revenue Code specifically includes amounts received as prizes and awards in gross income unless the prize or award is transferred directly to a charity.

These kickbacks are legally and logically distinct from the promotional materials vendors, including court reporting providers, routinely use generally to “get their name” out.

Given that the kickbacks from court reporting providers in exchange for business are payments for services rather than gifts, the Internal Revenue Code requires the recipients of those payments to treat the value of the incentives as gross income. This means that recipients must report the value of the incentives they receive as income on their tax returns. Failure to do so could result in the assessment of additional taxes, interest, and penalties by the Internal Revenue Service and the Franchise Tax Board.

So, these kickbacks are taxable income to somebody. The question is: what or who is the recipient? Could the Service or Board view these kickbacks as taxable income to the lawyer or law firm employer as opposed to the lawyer or law firm employee?

The answer is apparently uncertain. While the Service could view the kickbacks solely as income to the employee, the Service could also look at the fact that the income was earned within the scope of the employee's employment and impute the income to the law firm or lawyer employer.

Said another way, lawyers and law firms cannot with precision predict how the Service will treat this income. Liability may turn on the specific facts of each case.

This is exactly why most big law firms – including mine -- completely ban any such efforts to entice their employees to choose one vendor over another. We actively enforce this policy.

There are ethical issues raised by this practice, as well. Lawyers and law firms should not lightly allow their employees to accept kickbacks in the selection of any vendors, but especially court reporters. Court reporters are licensed professionals providing mission-critical services to clients. As well, according to the California Supreme Court, licensed court reporters providing deposition services are “ministerial officers of the court” – literally, extensions of the court operating privately. Thus, kickbacks in the selection of officers of the court raise ethical issues.

Moreover, when kickbacks rather than the quality and integrity of the reporter drive business, market forces no longer work as well as they should to promote quality and price, the two things most important to clients in the selection of a reporter.

For all these reasons, law firms and lawyers averse to tax liabilities may want seriously to consider the potential ethical, legal, and tax complications of allowing their employees to accept kickbacks.

However a lawyer or law firm confronts and resolves the question, it would be wise for the lawyer or law firm managing partner to make a decision with eyes open, realizing that the reporter scheduled to report their deposition, trial or court hearing may have been selected based solely on the kickbacks being offered rather than on bases important to the lawyer and the client.

Stephen J. Walwyn recently retired from the law firm of Mitchell & Walwyn in San Jose, where he specialized in plaintiff's personal injury representation. He is married to one of the founders of the California Deposition Reporter's Association, one of the nation's largest trade groups representing court reporters, including deposition reporters.