



Checking Boxes and Checking Your Forms: Why Understanding IRS Form 1099 is Key for Lawyers and Clients

By Robert W. Wood

Lawyers and their clients should care about IRS Forms 1099. Forms 1099 allow computer matching of Social Security numbers with dollar amounts paid and received, so IRS collection efforts are streamlined and automated. Read on to learn more about Forms 1099, changes in tax reporting, and how it can affect your practice.

In most cases, Forms 1099 report income, so if you receive a Form 1099 in the mail, open it and check the numbers. You may not be able to change it, but you'll usually need to report it on your tax return. Errors in reporting do occur, of course, so if you believe a Form 1099 is wrong, you may be able to get the issuer to correct or undo it. But that is usually tough unless it's truly an error.

For example, suppose that you receive a Form 1099 that says a company paid you \$100,000.00, but you can prove that the company actually paid you only \$10,000.00. You hope the company would correct that kind of error. But if you cannot get the company to correct it, you must report the \$100,000.00 and explain that you actually received only \$10,000.00.

Unfortunately, it is the experience of many that "please fix my Form 1099" requests fall on deaf ears. Often that is because the issuer of the form believes that the form was issued correctly. Also, many Form 1099 reporting issues that seem like errors really are not. Suppose you are a plaintiff, and you net \$60,000.00 from a legal settlement when your lawyer collected \$40,000.00, a 40 percent contingent fee. You will usually receive a Form 1099 for the full \$100,000.00, even if your lawyer was paid directly by the defendant and you only saw \$60,000.00. Arguing about that after the fact is nearly always a waste of time. The only time you have any bargaining power about how Forms 1099 will be issued is before you sign a settlement agreement.

Failing to report a Form 1099 on your tax return (or at least explain it) will get you an IRS notice. Thus, if you receive a Form 1099, report it – even if you are claiming that the money should be tax free. Report it even if some of it really went to your lawyer and you are entitled to a tax deduction for legal fees.

Ideally, if you are a plaintiff or a lawyer, you or your client should think about the forms before you sign a settlement agreement. In some cases, you might be able to steer the defendant to completely avoid a Form 1099. That would be appropriate if a portion of a settlement is fairly attributable to physical injuries, physical sickness, and/or emotional distress.

Even if it is certain that you will receive a Form 1099, there are different boxes on the forms that signal different notifications to the IRS. You should consider what the boxes mean,

and you may want to make it explicit that the defendant should record the payment in one box instead of another. What difference does a box make?

Boxes on Form 1099

Isn't one box on a Form 1099 as good as another? Not really, as we'll see. Concern over Forms 1099 causes some clients and lawyers to prefer separate checks: one for the funds payable to the client, and one for funds paid to the attorney directly. That way the attorney receives a Form 1099 for only the attorney fees, and not also for the client's money. And the client may think he can sidestep tax on the legal fees that way.

But let's look at the realities and the different boxes on a Form 1099 before you decide. The most common version used is Form 1099-MISC, for miscellaneous income. But to discuss it, we also must also talk about the newest one, Form 1099-NEC. Up until 2020, if you were paying an independent contractor, you reported it on Form 1099-MISC, in Box 7, for non-employee compensation.

Self-Employment Tax

In other words, Form 1099-NEC reports a payment for services. For 2019 and prior years, putting income in Box 7 of a Form 1099-MISC usually tipped the IRS off that this person should not only be paying income tax, but also paying self-employment tax. Self-employment tax is equivalent to both halves of the employer and employee payroll taxes that apply to wages, which are reported on Form W-2.

Self-employment tax can add a whopping 15.3 percent on top of income taxes. That 15.3 percent applies up to the wage base of \$137,700.00, with 2.9 percent tax thereafter on any excess over the wage base. There's no limit on that 2.9 percent, even if you earn millions. In short, self-employment tax is nothing to sneeze at. Up through 2019, if you were paying someone on a Form 1099, the main choice was between Box 3 and Box 7. Box 3 is for other income, a more neutral category compared to Box 7.

Because of the self-employment tax, most payees would rather receive amounts reported in Box 3 as opposed to Box 7. Sometimes you can specify where the amount is reported, such as in a legal settlement agreement. Otherwise, the payer of the money generally picks whatever reporting they think is best and issues the 1099. For payments in 2020 and later years, the IRS has a special form for independent contractors.

New Form 1099-NEC is specifically for paying independent contractors. Starting in 2020, do not use Form 1099-MISC for that purpose. Use Form 1099-NEC instead. It is very possible that, in early 2021, there could be considerable confusion about Form 1099-NEC, and there may even be some disputes. What happened to Form 1099-MISC now that Box 7 was essentially made into a whole new tax form?

Other Income v. “Gross Proceeds Paid to an Attorney”

As we will see, one exception is Forms 1099 that report gross proceeds to lawyers, a category that a surprising number of lawyers may not understand. For 2020 and subsequent-year payments, your choices on Form 1099-MISC are more limited. Most payments are recorded in Box 3, as other income. For lawyers settling cases, though, “gross proceeds paid to an attorney” is the most important category. Many lawyers may not see Forms 1099 that arrive at their office, but they should be aware of this important box on the form, and what it means for their taxes.

It impacts their clients, too. Up through 2019 payments, IRS Form 1099-MISC Box 14 was for gross proceeds paid to an attorney. That means the payments you received in 2019 that were reported in early 2020 were on these 2019 forms. For payments in 2020, they will be reported in January of 2021 on a new version of Form 2020-MISC.

For 2020 payments, good-old Form 1099-MISC still exists. “Gross proceeds paid to an attorney” for 2019 and prior years was Box 14. But now, it is reported in Box 10 of the new 2020 Form 1099-MISC. This box is only for reporting payments to lawyers. It turns out that there are numerous special Form 1099 rules for lawyers.

Why is the “gross proceeds paid to an attorney” category so important? For one thing, gross proceeds reporting for lawyers is not counted as income to the lawyer. Any payment to a lawyer is supposed to be reported, even if it’s all the client’s money to close a real estate deal. Case settlement proceeds count as gross proceeds, too.

Say that a lawyer settles a case for \$1 million, with payment to the lawyer’s trust account. Assume that 60 percent is for the client and 40 percent is for the lawyer as a fee. The lawyer is sure to receive a Form 1099 reporting the full \$1 million as gross proceeds. The lawyer need not report the full \$1 million as income, because it is not. In fact, the lawyer can simply report as income the \$400,000.00 fee without worrying about computer matching, since gross proceeds do not count as income. The client isn’t so lucky. Unless the settlement is a non-income settlement (compensatory damage for personal physical injuries) or a capital recovery, the client in this example will receive a Form 1099-MISC (probably in Box 3) for the full \$1 million. The client must then figure out how to deduct the \$400,000.00 in legal fees. Not all legal fees are deductible, and it is harder to find a way to claim them in many kinds of cases since 2018. In any event, apart from the very good deal that gross proceeds reporting is for lawyers, in other ways lawyers are disadvantaged when it comes to Forms 1099. Lawyers receive and send more Forms 1099 than most people, in part because of tax laws that single them out.

Lawyers, IRS Audits, and Forms 1099

Lawyers make good audit subjects because they often handle client funds, and many also tend to have high incomes. Since 1997, most payments to lawyers must be reported on a Form 1099. Of course, the basic Form 1099 reporting rule (for lawyers and everyone else) is that each person engaged in business and making a payment of \$600.00 or more for services must report it on a Form 1099.

The rule is cumulative, so while one payment of \$500.00 wouldn't trigger the rule, two payments of \$500.00 to a single payee during the year require a Form 1099 for the full \$1,000.00. Lawyers must issue Forms 1099 to expert witnesses, jury consultants, investigators, and even co-counsel when services are performed and the payment is \$600.00 or more. A notable exception to this \$600.00 threshold rule is payments to corporations for services. However, the rule that payments to a lawyer must be the subject of a Form 1099 trumps the rule that payments to a corporation need not be. Thus, any payment for services of \$600.00 or more to a lawyer or law firm must be the subject of a Form 1099. It doesn't matter if the law firm is a corporation, limited liability company, limited liability partnership, or general partnership.

The size of the law firm also doesn't matter; it might have one lawyer or thousands. This affects law firms as issuers of Forms 1099 as well as receivers of them. A lawyer or law firm paying fees to co-counsel or a referral fee to a lawyer must issue a Form 1099 regardless of how the lawyer or law firm is organized. Moreover, any client paying a law firm more than \$600.00 in a year as part of the client's business must issue a Form 1099.

Although many payments to lawyers can and should be reported as gross proceeds paid to an attorney (Box 10, starting with the 2020 form), not all payments to an attorney should be reported that way. For example, a payment of legal fees to the lawyer should probably be reported in Box 3. However, many parties seem to opt for gross proceeds reporting even then.

Some businesses and law firms prefer to issue Forms 1099 at the time they issue checks, rather than in January of the following year. For example, if you are mailing out thousands of checks to class action recipients, you might prefer sending a single envelope that includes both check and Form 1099, rather than sending a check and later doing another mailing with a Form 1099.

Joint Payees and Forms 1099

Lawyers are often joint payees, and IRS regulations contain extensive provisions governing joint checks. Most of these rules mean that lawyers will be receiving the forms along with their clients when legal settlements are payable jointly to lawyer and client. In general, two Forms 1099, each listing the full amount, are required.

Many lawyers receive funds that they pass along to their clients. That means law firms often cut checks to clients for a share of settlement proceeds. When a plaintiff law firm disburses money to clients for legal settlements, should the law firm issue a Form 1099 to its own client? Some firms issue the forms routinely, but most payments to clients don't actually require it. Even so, there is rarely a Form 1099 obligation for such payments.

The reason is that most lawyers receiving joint settlement checks to resolve client lawsuits are not considered payers. In most cases, the settling defendant is considered the payer. Thus, the defendant generally has the obligation to issue any Form 1099 necessary. If lawyers perform management functions and oversight of client monies, they become payers required to

issue Forms 1099, but just being a plaintiff's lawyer and handling settlement money is not enough.

Conclusions

Every tax return must be signed under penalties of perjury. That makes tax returns themselves the most important tax form of all. They are not to be taken lightly. Still, as many varieties of important tax forms as there are, it is hard to think of many that are more important or pivotal to our tax system than the little Form 1099 that most of us see every year.

Whether you are paying money or receiving money, consider these forms at tax time and throughout the year. And remember, not everyone is likely to agree on how and when the forms should be issued. There are hundreds of pages of IRS regulations about Forms 1099, and we have only scratched the surface here. Differences of opinion are common, even among seasoned tax professionals, so plan ahead.

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