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By || **ROBERT W. WOOD**

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Lawyers send and receive more IRS Forms 1099 than most people, in part due to tax laws that single them out. Here's what is most important to know about these forms, both for the upcoming tax season and year round in your practice.

IRS

Form 1099 reports interest, dividends, real estate sales proceeds, consulting income, retirement plan distributions, tax refunds, and many other categories of income. These forms are a major source of information for the IRS and state tax authorities, allowing matching of taxpayer identification numbers and dollar amounts. If you receive a Form 1099 that reports income but fail to put it on your tax return, you will almost certainly receive a tax notice. That can mean an audit of the income reported on the form, or an audit that extends to all other matters. These forms have a proven impact on tax compliance and collections. Taxpayers who receive a Form 1099 are much more likely to report the payment on a tax return. The forms also encourage efficiency in tax collections, as it takes little effort for the IRS to generate a bill to a taxpayer who fails to claim a payment reported on a Form 1099.

Lawyers send and receive more Forms 1099 than most people, in part due to tax laws that single them out. In the Taxpayer Relief Act of 1997, Congress enacted a provision¹ requiring companies that pay attorneys for services to report the payments to the IRS on a Form 1099. On its face, this may not seem like an important provision in the tax law. After all, regardless of whether they receive Forms 1099, lawyers should report all their fee income. Yet this rule has a significant impact on lawyers as recipients and as issuers of Forms 1099. Lawyers and law firms send as well as receive them.

Another reason to know about Form 1099 is to be sure your firm is in compliance with the law and can prove this in case you are audited. A recent IRS audit guide instructs IRS agents on what to look for when auditing lawyers, and lawyers may be good targets for audits

because they often handle client funds.² The IRS has long had an interest in the tax treatment of litigation settlements, judgments, and attorney fees, and has specifically targeted lawsuit settlements in a new IRS audit guide for its agents.³

Forms 1099 are not only important once a year at tax time. All lawyers in private practice—even those who have the benefit of an accountant or bookkeeper—should know the following basics about this form.

The basic reporting rule: Each person engaged in business and paying \$600 or more for services must report the payment on a Form 1099.⁴ The rule is cumulative, so while one payment of \$500 would

IRS Forms 1099 must be issued to the taxpayer by the last day of January in the year after the payment was made. Copies are due to the IRS at the end of February, along with a transmittal form summarizing the data. Most businesses wait a few weeks before sending the required copies to the IRS. In part, this is to allow for corrections. If someone receives an incorrect Form 1099 and promptly complains to the issuer, the correction can readily be made without filing multiple forms with the IRS to correct the error. Some businesses and law firms prefer to issue Forms 1099 when they issue checks. This practice is perfectly lawful and seems to be growing in popularity.

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not trigger the rule, two payments of \$500 to a single payee during the year require a Form 1099 for the full \$1,000.

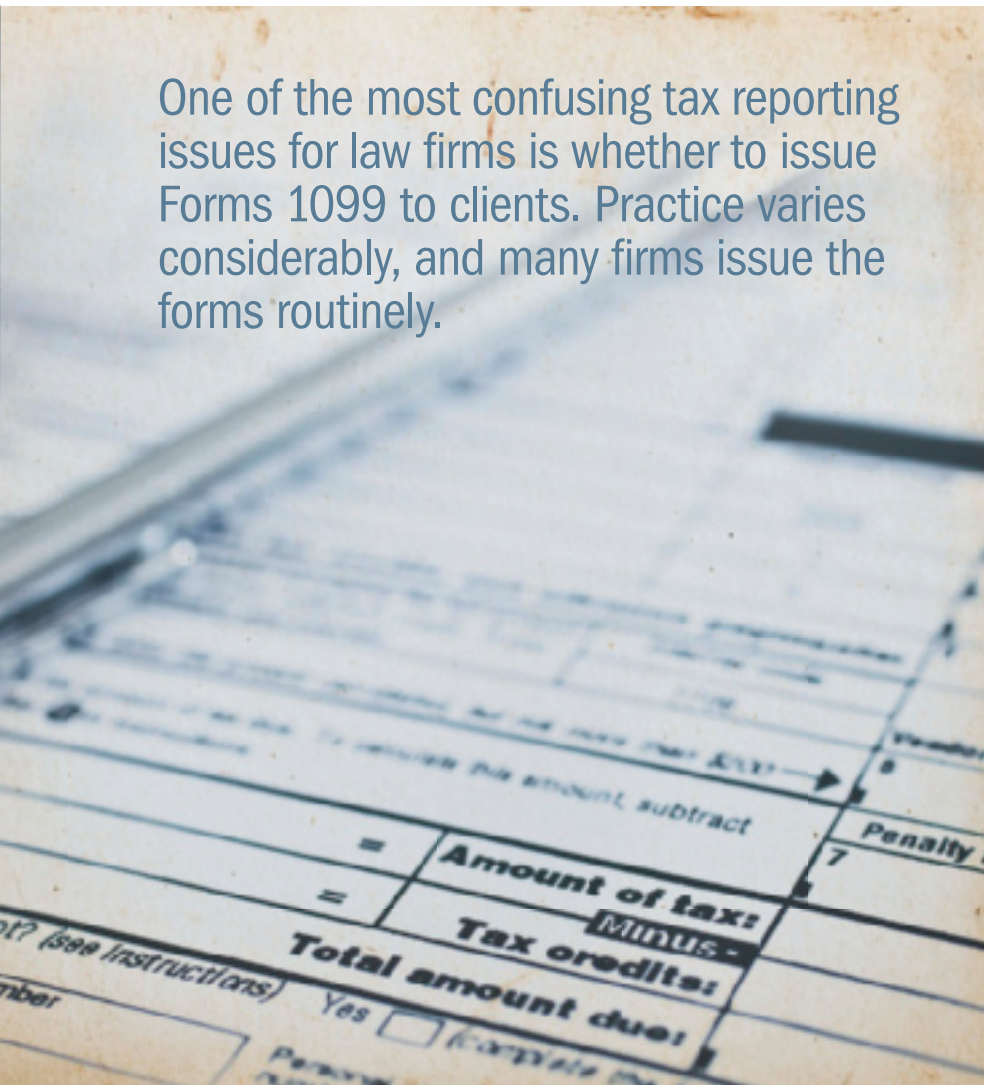
Lawyers must issue Forms 1099 to expert witnesses, jury consultants, investigators, and co-counsel whose services during the year reached the \$600 threshold. Although payments to corporations are generally exempt from Form 1099 rules, an exception applies to payments for legal services. Any payment for services of \$600 or more to a lawyer or law firm requires a Form 1099, regardless of whether the law firm is a corporation, LLC, LLP or general partnership.⁵ This applies to law firms both as issuers of Forms 1099 and as recipients. Conversely, any client paying a law firm more than \$600 in a year as part of the client's business must issue a Form 1099.

Forms 1099 and Clients

One of the most confusing tax reporting issues for law firms is whether to issue Forms 1099 to clients. Practice varies considerably, and many firms issue the forms routinely. Most payments to clients do not require the forms, however. When in doubt, issue the forms.

Settlement checks. When lawyers pass along settlement funds to their clients, such payments rarely require a Form 1099. Most lawyers who receive a joint settlement check to resolve a lawsuit are not considered payors. Rather, the settling defendant is the payor and is the party obligated to issue the form. If the settlement check is payable jointly to the lawyer and client and the defendant does not know how it will be split, it must issue a Form 1099 to each for the

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full amount. When the lawyer writes a check to the client for its share, the lawyer is not required to issue a form.⁶ If the defendant issues separate checks to the lawyer and client, it will give the lawyer a Form 1099 for his or her percentage. Plus, the defendant will give the client a Form 1099 for the full amount. The client will have to deduct the legal fee on its tax return to avoid paying taxes on the fees paid to its attorney.⁷

Personal physical injury payments. One of the many exceptions to Form 1099 rules applies to payments for personal physical injuries or sickness. Because such payments are tax free to the injured person, no Form 1099 is required. For

example, if an injured client receives a \$1 million settlement and the defendant issues a joint check to the client and his or her lawyer, the defendant need not issue a Form 1099 to the client, but must still issue one to the lawyer for the full \$1 million. If, however, the lawyer asks for a \$600,000 check issued to the client and a \$400,000 check issued to the lawyer, the lawyer should get a Form 1099 for \$400,000.

Other payments to clients. Refunds of legal fees to clients raise another issue. If the refund is of monies held in the lawyer's trust account, no Form 1099 is required. If the law firm was previously paid, however, and is refunding

the client from the law firm's own income, a Form 1099 is needed.⁸

Oversight and Management

Under IRS regulations, if lawyers exercise management and oversight of client monies, they become payors. The "payor" must report the payment on a Form 1099. A person making payment on behalf of another is a "payor" if he or she either: (1) performs management or oversight functions in connection with the payment; or (2) has a significant economic interest in the payment. Whether a lawyer is a "payor" under these rules is a question of fact. If a lawyer performs management and oversight functions—like an escrow agent—the lawyer is a payor and must issue Forms 1099 to clients. However, "management and oversight" does not include performing "mere administrative or ministerial functions such as writing checks at another's direction."⁹ Surprisingly, most lawyers are viewed as the agent of their clients under these rules. That means, generally, that lawyers are not required to issue a Form 1099 to the client when disbursing settlement monies in a contingent fee case. The "payor" in that situation is the defendant, not the plaintiff's lawyer.

IRS regulations contain extensive provisions governing joint checks. Most of these rules mean that lawyers will be receiving the forms. For example, if a defendant settles a case and issues a joint check to the lawyer and client, the defendant normally must issue one Form 1099 to the client for the full amount and another to the lawyer for the full amount. As a result, the attorney may prefer separate checks. Seeking to help their clients avoid receiving Forms 1099, some plaintiff lawyers ask the defendant for one check payable to the "Jones Law Firm Trust Account." Treasury Regulations treat this just like a joint check, so two Forms 1099—each in the full amount—are required.

Requirements to issue Forms 1099 have existed in the tax code and parallel state laws for decades and have become more rigorous in recent years. Penalty enforcement has also gotten tougher. More and more reporting is now required, and lawyers and law firms face not only the basic rules but the special rules targeting legal fees.

Lawyers are not always required to issue Forms 1099, especially to clients. Nevertheless, the IRS is unlikely to criticize anyone for issuing more forms than necessary. Perhaps for that reason, it is becoming common for law firms to issue Forms 1099 to clients even where they are not really needed.

It pays to review these rules and be careful. Most penalties for inadvertent failures to file are modest—as little as \$50 per form.¹⁰ The penalty is aimed primarily at large-scale failures, such as where a bank fails to issue thousands of the forms to account holders. However, law firms should be careful about these rules, too. The distribution of the proceeds of a class action, for example, can trigger large-scale issuances of Forms 1099.


In addition to the \$50 per failure penalty, the IRS may also try to deny a deduction for the item that should have been reported. That means if you fail to issue a form for a \$100,000 consulting fee, the IRS could claim it is non-deductible. It is usually possible to defeat this kind of draconian argument, especially since the tax code does not explicitly tie the availability of a business expense deduction to the issuance of a Form 1099. Nevertheless, the mere fact that an IRS auditor may raise the specter of the denial of a business expense deduction can be a frightening prospect.

Another danger is the penalty for intentional violations. Taxpayers who intentionally ignore the obligation to issue a Form 1099 are asking for trouble: The IRS can impose a penalty equal to 10 percent of the payment amount.¹¹

Fortunately, perhaps because of the difficulty of proving that the taxpayer intentionally violated the reporting rules, the IRS seems to rarely seek the application of this 10 percent penalty.

The reach of the Form 1099 rules is surprisingly broad and can even impact whether workers are independent contractors or employees. For example, suppose that an attorney fails to issue Forms 1099 to jury consultants and contract lawyers. Although the lawyer and the jury consultants or contract lawyers may agree they are independent contractors, the IRS can use the failure to issue Forms 1099 as evidence that they are really the attorney's employees.¹²

Since Forms 1099 require taxpayer identification numbers, attorneys are commonly asked to supply payors with their own taxpayer identification numbers and those of their clients. Usually such requests come on IRS Form W-9. If an attorney is requested to provide a taxpayer identification number and fails to provide it to a paying party, he or she is subject to a \$50 penalty for each failure to supply that information. The payments to be made to the attorney may also be subject to back-up withholding. The IRS can require back-up withholding when names and Forms W-9 do not match IRS records. Where required, it is generally done at a flat 28 percent rate.¹³ As a practical matter, some defendants may simply refuse to turn over the money without the required taxpayer identification numbers or will seek to pay the money to a court.

Most people do not like issuing or receiving Forms 1099. But lawyers, more than many other professionals, need to pay special attention to these rules. The IRS is watching. 

Robert W. Wood is a tax lawyer with a nationwide practice. He can be reached at Wood@WoodLLP.com. ©2012 Robert W. Wood.

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NOTES

1. Pub. L. No. 105-34.
2. See IRS, *Attorneys Audit Technique Guide* (Rev. Mar. 2011), www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Attorneys-Audit-Technique-Guide.
3. See IRS *Lawsuits, Awards, and Settlements Audit Techniques Guide* (Rev. May 2011), www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Lawsuits,-Awards,-and-Settlements-Audit-Techniques-Guide; see also Robert W. Wood, *IRS Targets Lawsuit Recoveries for Audit*, 133 Tax Notes 1543 (Dec. 19, 2011).
4. 26 U.S.C. §6041.
5. 26 U.S.C. §6045(f).
6. See discussion in Robert W. Wood, *Final Regulations Fuel Fuss Over Attorney Fee Reporting*, 112 Tax Notes 929 (Sept. 11, 2006).
7. This deduction may be a miscellaneous itemized deduction and thus may trigger the alternative minimum tax. See Robert W. Wood, *AMT Problems For Attorney Fees Remain*, (Dec. 22, 2010), www.forbes.com/sites/robertwood/2010/12/22/amt-problems-for-attorney-fees-remain/.
8. See 26 U.S.C. §6041(a).
9. See Robert W. Wood and Jonathan R. Flora, *New (Final!) Form 1099 Reporting Regs: Attorneys' Fee Regs in Drag?*, 97 Tax Notes 265 (Oct. 14, 2002).
10. 26 U.S.C. §6722.
11. See 26 U.S.C. §6721(e).
12. See Robert W. Wood, *Employee Versus Independent Contractor Determinations Can Be Difficult in Cases Involving 'Of Counsel' Lawyers*, 24 BNA Daily Tax Rep. 1 (Dec. 23, 2007).
13. See 26 U.S.C. §§6041-6043.