

EMPLOYMENT LAWYERS FACE HIDDEN FINAL IRS RULES ON FORMS 1099 FOR ATTORNEYS

by Robert W. Wood* and Jonathan R. Flora**

Rarely is the IRS compared to Greeks bearing gifts. Still, a Trojan horse metaphor isn't entirely inapposite. Missives from the IRS that seem innocuous, even kindly, can hide sinister weapons. Regrettably, that is just the situation with recently issued final regulations on information reporting for payments made on behalf of others.¹ Following the prevailing moniker for this kind of payment and information reporting, we'll refer to the new regulations as the "Middleman regulations."

As many lawyers know (tax lawyers, plus a goodly number of litigators and general practitioners), rules governing reporting of payments to attorneys – the dreaded Form 1099 requirements – have been extraordinarily controversial. One of the more controversial rules is section 6045(f). Enacted in 1997, this section requires most payments to attorneys to be reported on a Form 1099. Although no regulations were required to implement this mandate, several sets of proposed regulations have already been issued.²

Had there not been a huge outcry – a veritable lawyers-turned-tax-protestors revolt against reporting – the rules in these regulations (with their myriad of duplicative reporting regimens) would already be law. As it is, the Service issued a new set of proposed regulations in May 2002.³ (We'll call these the "Attorney Payment

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¹ T.D.9010 (July 25, 2002); 2002 TNT 144-10; Doc 2002-17313.

² For a discussion, see Wood, "Proposed Attorney Fee Reporting Regulations: Deja Vu?", Vol. 96, No. 3, Tax Notes (July 15, 2002), p. 409.

³ REG-126024 (May 16, 2002); 2002 TNT 96-5.

regulations.”) Though the proposed Attorney Payment regulations are certainly not perfect, it seemed lawyers could rest easy for a spell knowing that they would not become effective until two months after they are finalized.

Wheel in the Trojan Horse

That was then. Sighs of relief about effective dates are turning to squeals of torment, or at least groans of anguish. The Service has just rolled out final Middleman regulations, ostensibly aimed at escrow agents and others who make payments on behalf of another person. They are effective January 1, 2003. Yawn.

Low and behold, lurking in the belly of the Middleman regulations are reporting rules for payments by and to attorneys and clients, rules that have little to do with escrow agents, and lots more to do with an acidic split in the Federal Circuits and the revolt over the Attorney Payment regulations. But we are getting slightly ahead of ourselves.

There is a well publicized rift between the Federal Circuits on the question of whether the portion of a damage award or settlement payment used to pay fees of a plaintiff's attorney is includible in the gross income of the plaintiff. Some Circuits hold that a plaintiff must include attorneys' fees in his gross income, while others allow him to exclude those fees and report only the net amount he receives.⁴ When attorneys' fee payments are included in a plaintiff's gross income, the plaintiff is generally entitled to a deduction, but it is typically a miscellaneous itemized expense. The uninitiated may not see much difference between an exclusion and a deduction. But, as we all know, the benefit of this deduction is often reduced (and can be virtually eliminated) because of the alternative minimum tax regime.⁵ Plus, sections 67 and 68 impose further haircuts on the deduction.⁶

⁴ Compare *Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir. 2001), cert. denied sub nom. *Sinyard v. Rossotti* (70 U.S.L.W. 3598, June 10, 2002) (including fees in plaintiff's income), *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000) (excluding fees from plaintiff's income).

⁵ See §56(b)(1)(A).

⁶ Section 67 generally allows a deduction only to the extent it exceeds 2% of the taxpayer's adjusted gross income. Section 68 also reduces certain allowable itemized deductions by three percent based on the extent a

Up to now, the reporting rules have not been explicit in requiring a payor to issue a Form 1099 to the client for the attorney payment in those states and Circuits holding that an attorney payment is gross income to the client. This may seem like splitting hairs (what else do lawyers do?), but a plaintiff who does not receive a Form 1099 showing the attorneys' fees at least has more of a fighting chance.

It is not surprising that this legal nicety would one day end, particularly given the controversy surrounding the hotly divided circuit courts on this issue. But, it seemed likely that the Service would put the controversy to rest only through final Attorney Payment regulations. After all, even the Service has referred to the Attorney Payment regulations as those "relating to the reporting of payments of gross proceeds to attorneys."⁷

Much like a game of football when suddenly several players start playing rugby, the Service has done a kind of end run (okay, no more sports metaphors) and put the new 1099-for-attorneys-fees-gotcha in a plain brown wrapper (or, if you prefer, a wooden horse) – the Middleman regulations. This will catch a lot of people off guard, particularly plaintiffs' lawyers who have been fighting about the likely effects the Attorney Payment regulations will have. The working assumption has been that it would be some time before those rules were finished.

Surprise!

Gross Income Reportable to a Plaintiff

The Middleman regulations, in addition to providing rules for who must report payments made on behalf of another (discussed below), also include a rule for the amount a payor

taxpayer's gross income exceeds the "threshold amount," which for 2002 is \$137,300.

⁷ Preamble, T.D. 9101 (2002). The description also states the regulations "clarify the amount to be reported," which we suppose in hindsight should have been a red flag. Moreover, a proposed version of these regulations issued in October 2000 contained a version of the attorney payment rule. REG-246249-96; 2000 TNT 205-54 (Oct. 17, 2000).

must report when a payee takes deductions from the payment.⁸ Beginning in 2003, a payor must report the amount includible in the gross income of the payee before fees, commissions, expenses or other amounts have been deducted.⁹ This rule applies “whether the payment is made jointly *or separately to the payee and another person.*” *Id.* (emphasis added).

The examples in the Middleman regulations make clear that this rule controls whether a defendant must report to a plaintiff the payments the defendant makes to the plaintiff’s lawyer that represent the lawyer’s own fees.¹⁰ The Middleman regulations generally require a defendant to issue a plaintiff a Form 1099 that *includes* the attorneys’ fee payment whenever that payment is includible in the plaintiff’s gross income.

Example 1. Attorney represents Client in a claim for lost profits against Defendant. It settles for \$140,000. Defendant issues a \$40,000 check to Attorney and a \$100,000 check to Client. Under the law that applies to the Client, Client is required to include a portion of the recovery that pays his attorneys’ fees in his gross income.

The Middleman regulations now require (beginning in 2003) that Defendant issue a Form 1099 to Client showing \$140,000.¹¹ But, reporting would not be required if the payment was not includible in Client’s gross income. Of course, defendants pay recoveries in Circuits in which a plaintiff must include the amount, in Circuits in which he must not, and in Circuits that have not issued decisions on the issue.¹² The regulations

⁸ Reg. §1.6041-1(f).

⁹ Reg. §1.6041-1(f).

¹⁰ Reg. §1.6041-1(f)(2), Example one.

¹¹ Reg. §1.6041(f)(2) Ex. 2.

¹² The Circuits that have issued decisions on this issue are the Court of Appeals for the Third, Fourth, Fifth, Sixth, Seventh, Ninth and Eleventh Circuits. For a discussion, see Wood, “The Plight of the Plaintiff: The Tax Treatment of Legal Fees; Vol. 81, No. 7 Tax Notes (Nov 16, 1998), p.907

try to resolve this disparity by requiring a defendant to report the amount that is includible in the plaintiff's gross income under "applicable law."

A defendant, then, to comply with section 6041, must analyze the substantive law on attorneys' fees inclusion as it applies to a plaintiff before he reports a payment. This is even more tricky than it may seem. Not only have some Circuits not yet ruled on this issue, the IRS has assumed a restrictive stance — it contends that even in those Circuits that permit a plaintiff to exclude attorneys fees, that rule applies only to taxpayers who reside in certain states within those Circuits.¹³

Section 6041 and Middlemen

So much for the big surprise in the Middleman regulations. Let's turn to the portion of the Middleman regulations that really deals with middlemen — after all, this is the ostensible reason for the regulations.

Section 6041 contains the general reporting rule for payments of \$600 or more made in the course of a trade or business. It requires a payor to report for payments of salaries, wages, compensation, fees and other forms of fixed or determinable income.¹⁴ Some limitations are built into the general rule. For example, section 6041 does not apply to reporting payments outside of a trade or business. Thus, it does not apply to legal fees paid for a divorce since those are personal expenses.¹⁵ It also does not apply to payments that are not gross income to the payee.¹⁶ For example, settlement payments

¹³ Those states are Alabama, Michigan and Texas. See *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), *aff'g. in part and rev'g. in part* 28 T.C. 947 (1957); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000); *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000). The IRS issued MSSP Audit Guide for Lawsuit Awards and Settlements (1 Jan 2001), 2001 TNT 18-6, in which it stated "taxpayers should not be allowed to net the proceeds of the direct payment of attorneys' fees in all cases arising under any law other than Alabama, Michigan and Texas."

¹⁴ §6041(a).

¹⁵ Rev. Rul. 85-101, 1985-2 C.B. 301 (1985).

¹⁶ See, e.g., Ltr Rul. 8722088, 1987 WL 420654 (1987).

for physical injury or physical sickness excludable under section 104(a)(2) do not require reporting.¹⁷

The Middleman regulations are a subset of section 6041's general reporting rule. They apply to persons making payments on behalf of another (in other words, “middlemen”). The rules try to answer the question of who is the “payor” for purposes of section 6041, and therefore tell us who must report the payment.

Example 2. Bank provides financing to Developer in connection with a constructing a real estate project. Bank (on behalf of Developer) pays for contractor services and materials from its financing account.

When it comes to issuing Form 1099s for the payments, is Bank or Developer the “payor” under section 6041?¹⁸ The Middleman regulations resolve (or at least purport to resolve) this issue. While these regulations obviously apply to escrow agents, their scope reaches further than one might imagine and includes payments made by attorneys. (See our Example 6, below.)

According to the Middleman regulations, a person making payment on behalf of another is a section 6041 “payor” if he either:

- (i) performs management or oversight functions in connection with the payment;
- or
- (ii) has a significant economic interest in the payment.¹⁹

Consider another example.

¹⁷ See, e.g., IRS 2002 Instructions for Form 1099-MISC, at pp. 3-4 (instructing taxpayers not to report payments of damages received on account of personal physical injury or sickness).

¹⁸ See Reg. §1.6041-1(e)(5) Ex. 1.

¹⁹ Reg. §1.6041-1(e)(1).

Example 3. Mortgage Company holds a mortgage on property owned by a Debtor. The property is damaged in a fire. Debtor's insurance company issues a check to Mortgage Company who holds the proceeds in escrow. Mortgage Company cuts checks from these proceeds to pay subcontractors working on the property.

Although Mortgage Company is making payments on behalf of Debtor, the Middleman regulations conclude Mortgage Company is a "payor" for purposes of section 6041 and must therefore file information reports. Why? Because Mortgage Company has an economic interest in the repaired property.²⁰

Ambiguity in "Management and Oversight"

For attorney-related payments, it is the "management and oversight" prong that is most likely to trigger reporting duties. Unfortunately, the Middleman regulations do not define this term except in the negative. In particular, they state "management and oversight" does not include a person who "performs mere administrative or ministerial functions such as writing checks at another's direction."²¹ "Management and oversight," according to the preamble, is a question of fact.

The most helpful guidance is found in the examples²². Let's look at two of these fact patterns, one with sufficient management and oversight, the other without.

Example 4.²³ Bank provides financing for Developer's real estate project. Bank takes the following acts with respect to payments it makes on Developer's behalf:

²⁰ Reg. §1.6041-1(e)(5) Ex. 2. The Middleman regulations define an economic interest as one that would be compromised if the payment were not made, such as a mechanic's lien on property or loss of collateral.

²¹ Reg. §1.6041-1(e)(1)(i).

²² Reg. §1.6041-1(e)(5).

²³ See Reg. §1.6041-1(e)(5) Example 1. This example appears to be based on Revenue Ruling 93-70, 1993-2 C.B. 294 (1993), which was rendered obsolete by the Middleman regulations.

- approves payments to contractors;
- ensures loan proceeds are properly applied;
- ensures that all bills are paid to avoid mechanic's liens; and
- conducts site inspections to determine whether work has been completed (but does not check the quality of the work).

The Middleman regulations say that Bank performs management and oversight and so must report the payments. But, it is unclear whether these facts must all be present to trigger reporting, or whether only one (or some combination of them) will trigger reporting duties. As presented in the Middleman regulations, the example strings all the factors together but does not include a helpful conjunctive, such as “or” or “and.” (Come on, these are only final regulations after all!) Would the bank, for example, be required to report if it had not conducted site inspections? Presumably not all of these items must be present, but it simply isn't clear from the Middleman regulations. What is clear is that there is no litmus test.

Example 5.²⁴ Agent, who represents Author, receives a payment from Publisher for a novel written by Author. Agent deposits the money into an account in Author's name. Agent applies the proceeds to pay attorneys, managers and other third parties, all of whom rendered services to Author. With respect to these payments, Agent:

- does not order or direct the provision of services by the third parties; and
- exercises no discretion in making the payments to third parties or to the client.

After making these payments, Agent pays the net amount to his client.

²⁴ Reg. §1.6041-1(e)(5) Ex. 6.

The Middleman regulations conclude Agent has not performed management and oversight functions, and so he has no reporting obligations under section 6041.

What can we glean from these examples? It certainly seems to matter how much control a middleman exercises over both making payments themselves and the services for which they are made. But beyond that, there is much grey area. Perhaps the most we can take away from these rules is that anyone making payments on behalf of another who has discretion over the payment amount, timing, or services provided should look very carefully at the Middleman regulations (or else just report the payments). The latter — just report whenever in doubt — may be one of the Service's most insidious messages.

Reporting Duties Under Section 6045(f)

Enacted as part of the Taxpayer Relief Act of 1997, section 6045(f) explicitly imposes reporting obligations on certain attorney-related payments, in addition to those found in section 6041 and the Middleman regulations. Section 6045(f) generally requires information reporting for any payment made to attorneys with respect to legal services, even where the services were not provided to the payor. For example, a third party, such as a defendant's insurer who issues a settlement check to the claimant's attorney, may be required to report the payment.

Section 6045(f) became effective on December 31, 1997. The Service first issued proposed regulations on May 21, 1999.²⁵ It withdrew the regulations before they became effective and issued another set of proposed regulations on May 17, 2002²⁶ (again, this article dubs them the Attorney Payment regulations). It's important to stress

²⁵ 64 F.R. 27730, 1999-1 C.B. 1193. For a discussion, see Wood, "More Confusion Over 1099s," Vol. 92, No. 9, Tax Notes (Aug. 27, 2001), p. 1215.

²⁶ 67 Fed. Reg. 355064

that these regulations are not now effective, and will not become effective until two months after they are finalized.²⁷

Piecing together the Puzzle

With these navigational tools in hand, it is worth exploring an example involving payments to attorneys and clients to see how the Middleman regulations interpret the effect, and interrelation, of sections 6041 and 6045(f).²⁸

Example 6. Paula Plaintiff, a claimant in an employment action, recovered from Egregious Employer, her former employer, lost profits in a claim for breach of contract. Egregious paid the fees into a trust account maintained by Lawrence Lawyer, Paula's attorney. Lawrence used the funds to pay experts, costs and other litigation expenses. With respect to those payments, Lawrence decided whom to hire, he negotiated the amount of payment, and he determined whether the services were performed satisfactorily. Lawrence also had the right to withhold payment in the event of a dispute. After paying his own fees, Lawrence paid the net amount to Paula.

According to the Middleman regulations, here is how sections 6041 and 6045(f) apply to the reporting obligations of Lawrence, Paula and Egregious:

1. Lawrence's payments to the third parties. The Middleman regulations apply to Lawrence's payments for experts, costs and litigation expenses. Lawrence made these payments on behalf of Paula; his reporting duties therefore depend on whether he performed management and oversight functions or had a significant economic interest in the payments. The Middleman regulations tell us that under these facts Lawrence

²⁷ Id. For a full discussion, see Wood, "Proposed Attorney Fee Reporting Regulations", Vol. 96, No. 3, Tax Notes (July 15, 2002), p. 409.

²⁸ This example is closely based on Examples 7 and 8 in the Middleman regulations. See Reg. 1.6041-1(e)(5) Examples 7 and 8.

performed management and oversight functions. They do not tell us, however, which act(s) was determinative. Lawrence must file information reports for these payments.

Of course, since management and oversight is a question of fact (and there is no litmus test), it is quite possible that an attorney will *not* be performing management and oversight functions for these types of payments. Remember the literary agent in example 5? He (like Lawrence) paid professionals who provided services to his client, but he (unlike Lawrence) did not perform management and oversight functions. If a client were responsible for, say, hiring an expert, negotiating payments, or approving his work, the attorney making payments to the expert may very well not be required to report the payment under section 6041.

2. Lawrence's payment to Paula. Lawrence paid to Paula the net proceeds that Egregious owed her as a result of the lawsuit. In other words, he made the payment on behalf of another. The Middleman regulations conclude (without analysis) that Lawrence neither performed management and oversight functions as to this payment nor had a significant economic interest in it. Lawrence therefore has no information reporting duties for this payment under section 6041.

Once again, since the tests in the regulations are grey and questions of fact, it is at least theoretically possible that reporting under section 6041 may be required when an attorney pays a net recovery amount to a client. However, it is difficult to imagine such a case.

3. Egregious' Payment to Lawrence. The Middleman regulations instruct Egregious to “see” section 6045(f) for its reporting duties, suggesting that section 6041 does not require Egregious to report the payment. This result is consistent with the preamble to the Middleman regulations when they were proposed in October of 2000.²⁹ The preamble at that time explained that a defendant does not perform management or oversight functions in connection with payments to a claimant's attorney (and thus is not

²⁹ 65 F.R. 61292, 2000 TNT 205-54 (2000)

a section 6041 “payor”). A defendant is therefore not required to report the payment under section 6041. According to the preamble, “[t]he plaintiff, not the defendant, is required to report the payment of attorney fees to plaintiff’s attorney under section 6041.”

Egregious is not out of the woods yet — it must still contend with section 6045(f). This complicates matters. If section 6045(f) were to employ the same definition of “payor” as in section 6041, then it appears Egregious would not be a payor under either section. It could legitimately argue that neither section required it to report the payment.

The preamble to the Attorney Payment regulations attempts to cut the legs off of this argument. The preamble states that “payor” is defined differently for purposes of section 6045(f) than for section 6041. According to the preamble, the Service and Treasury believe Congress intended for section 6045(f) to apply to payments by insurers and defendants to a plaintiff’s attorney. The Attorney Payment regulations try to force Egregious to report the payment by defining “payor” to include “an obligor on the payment, or the obligor’s insurer or guarantor.”³⁰ Egregious, then, is not a “payor” under the Middleman regulations, although it is a “payor” under the proposed Attorney Payment regulations.

Remember, though, that the Attorney Payment regulations are not yet effective, and they will only become effective if they are finalized. Until that time, the definition of “payor” under section 6045(f) is somewhat up for grabs. Egregious, for example, conceivably could argue the definition of “payor” in section 6041 applies to section 6045(f). In that case, Egregious would not be required to report under either statute.

4. Egregious’ Payment to Paula. For this payment, the Middleman regulations instruct Egregious to “see” the section 6041 regulations setting forth the general reporting rule (Regs. §1.6041-1(i) and (f)),³¹ which indicates the payment is outside the scope of the

³⁰ Prop. Regs. §6045-5(d)(3).

³¹ The reference is to existing paragraph (f), which is renumbered by the 2003 regulations as paragraph (h).

Middleman regulations. Thus, Egregious must report the payment to Paula if it otherwise qualifies under section 6041 — *e.g.*, it is \$600 or more, made in the course of Egregious' trade or business, and constitutes gross income to Paula.

Assuming Egregious is required to report the payment, it may be required under the Middleman regulations to report the entire (gross) amount of the payment which Paula is required to include in her gross income, including Lawrence's legal fees.³²

Determining the correct amount to report to Paula requires Egregious to determine: (i) which Circuit's law applies to Paula; (ii) whether, under the law in that Circuit, Lawrence's fees are includible in Paula's gross income; and, (iii) if the plaintiff is in a Circuit in which attorneys' fees are excluded, whether the Service is right in restricting that rule to certain states within the Circuits.³³

The Middleman regulations are silent as to which set of rules apply to payments made by a defendant's insurer. One might suspect the insurer's payment is to be governed by the same rules that apply to Egregious. Yet, there is a factual difference. Egregious' payments arose from services Paula performed for it. A payment by the insurer would be for services Paula rendered to someone else — Egregious. Thus, the insurer would arguably be making payment on behalf of Egregious. As such, it may (unlike Egregious) be operating under the Middleman regulations. In that event, the insurer's reporting obligations under section 6041 would turn on whether it performed management and oversight functions or had an economic interest in the payment.

5. Paula's Payment to Lawrence. The Middleman regulations instruct Paula to see the general 6041 reporting rule (section 1.6041-1(a)(i)) as well as the particular rule for payments for professional services. It appears that Paula may be required to report the portion of Egregious' payment that constitute Lawrence's fees to Lawrence,³⁴ although

³² See §1.6041-1(f).

³³ On this point, see footnotes 12 and 13.

³⁴ This result is consistent with the preamble to the Middleman regulations when they were proposed in October 2000, which, as we mentioned earlier, conclude that "[t]he plaintiff, not the defendant, is required to report the

her reporting duties would be subject to the limitations on the general reporting rule. For example, the payment of the attorneys' fees by Paula would not need to be reported if it was occasioned by personal reasons such as a divorce.

Conclusion (or Wake)

Navigating reporting obligations for attorney-related payments has never been easy. With the Middleman regulations, reporting duties now turn on somewhat unsettled standards. When is a payor performing management and oversight functions? When does a payor have a significant economic interest in the payment? What amount of an award or settlement payment is includible in a plaintiff's income (and is the payor in a position to know, given the volatility of this position)? Unless these questions are answered, and answered correctly, it seems fairly easy, and indeed even likely, to run afoul of the profusion of reporting rules.

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payment of attorney fees to plaintiff's attorney under section 6041." 65 F.R. 61292, 2000 TNT 205-54 (2000).