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Proposed Attorney Fee Reporting Regulations: Déjà Vu?

By Robert W. Wood

When you make a payment to your lawyer for legal fees arising out of a trade or business, is it subject to reporting on Form 1099? The answer to this is generally yes. If you are a defendant in a lawsuit and make a payment to the plaintiff's lawyer and his client, is that also subject to reporting? The answer to this is also yes, although the scope and manner of the reporting has been hotly debated over the last few years. If anything, the reporting requirements now make addressing tax issues arising in a settlement or judgment even more critical, since putting one's best foot forward can go a long way toward positioning the settlement or judgment for desirable tax treatment.

Section 6045(f) was added by the Taxpayer Relief Act of 1997, adding to the web of Form 1099 requirements already in the code. This provision generally requires Form 1099 information reporting for payments of gross proceeds made in the course of a trade or business to attorneys in connection with legal services. Although it might on the surface sound as if this reporting is only for payments to your own lawyer, there need not be a lawyer/client relationship for a payment to be reported. Third-party payors — for example, companies settling a lawsuit — are covered.

Proposed regulations were issued in May 1999, and were immediately assailed as overly burdensome. See REG-105312-98, 64 Fed. Reg. 27730, *Doc 1999-18165 (18 original pages), 1999 TNT 98-17.* At the heart of the proposed regulations was the notion that there could be duplicate Form 1099 reporting — both to the lawyer and the client — on the same dollars. Indeed, a hallmark of the proposed regulations issued in 1999 was that a $100,000 settlement payment issued in the traditional joint manner "pay to the order of Cleo Client and Larry Lawyer" would result in a Form 1099 to Larry Lawyer for $100,000 and a separate Form 1099 to Cleo Client for the same amount. Trial lawyer groups were some of the loudest objectors to this two-fisted net, but objections came from nearly all quarters.

As originally proposed, these regulations would have applied to payments made after December 31, 1999. After a good deal of criticism, the IRS announced in Notice 99-53, 1999-46 IRB 1 (Oct. 27, 1999), *Doc 1999-34653 (1 original page), 1999 TNT 208-7,* that the effective date for these proposed regulations would be delayed for one year. Thus, they were to go into effect for payments made after December 31, 2000.

There was another postponement, however. In January 2001, the IRS announced that the proposed regulations would not be effective until finalized. See Notice 2001-7, 2001-4 IRB 1 (Dec. 22, 2000), *Doc 2001-120 (2 original pages), 2000 TNT 248-12.* Treasury Department representatives later said that further changes were in the works, that these regulations would be reproposed, and would not be effective until the new proposed regulations were made final. In addition, there would be a two-month grace period.

The proverbial other shoe has finally fallen, with the publication on May 17, 2002, of new proposed regulations. See REG-126024-01, vol. 67, Fed. Reg. No. 96, p. 35064 (May 17, 2002), *Doc 2002-12130 (7 original pages), 2002 TNT 103-10.* As promised, these rules will apply only to payments made during the first calendar year that begins at least two months after the date of publication of the final regulations in the *Federal Register.* It is unclear, of course, how much the final version of the regulations — when they come out — might vary from these newly proposed ones. As you will see below, some important changes were made from the prior version of these proposed rules. Nevertheless, many groups will likely criticize even this more relaxed version of the proposed reporting regulations.

Duplicate Reporting?

As with the earlier proposed regulations, the new 2002 proposed regulations made clear that double counting is still possible. Indeed, in the classic joint payee check settlement of a case ("pay to the order of Claude Client and Lavonne Lawyer"), unless the payor has knowledge of who is ultimately getting what, duplicate Forms 1099 to lawyer and client will be required. The IRS has explained that the payment to the lawyer will be a "gross proceeds" Form 1099. The IRS has changed the basic Form 1099-MISC to include a new gross proceeds box. The idea, the IRS says, is that unlike many of the other boxes on that form indicating income in the full amount — for example, nonemployee compensation — the gross proceeds designation merely means that the attorney was provided funds in that amount.

At the same time, most attorneys will probably want to avoid the possibility of a mismatching of the Forms

1099 with the amounts shown as gross income on their tax returns. Thus, most attorneys receiving gross proceeds Forms 1099 will likely want to show the entire amount as gross income, with the amounts disbursed to clients shown as business expense deductions. This ends up overstating gross income. The alternative, taking the position that the full amount was not gross income — and that the gross income of the lawyer would only represent that person's portion of the check — may give the lawyer a more accurate picture of his gross income. However, there may be a risk of a mismatching. There appears to have been no discussion on how gross proceeds Forms 1099 will fit into the IRS information return matching system.

However that issue is resolved, one of the great changes that will occur — at least it should occur — concerns the manner in which the settlement checks are written. Lawyers should increasingly want to have their cases settled by at least two checks, one directly to the client and one to the lawyer. From a reporting perspective, that will be better for the lawyer. In some cases, it can be better for the client, too.

> Example 1 (joint payees): Edgar Employee, who is represented by Al Attorney, sues Dastardly Employer for back wages. Dastardly settles for $300,000, which represents taxable wages. Dastardly writes a settlement check jointly to Edgar and Al for $200,000, net of income and FICA tax withholding. Dastardly delivers the check to Al. In turn, Al retains $100,000 of the payment and disburses the remaining $100,000 to Edgar. Dastardly must issue an information return (presumably a W-2 rather than a Form 1099, although the proposed regulations do not specify) to Al for $200,000. Dastardly must also issue a Form 1099 to Edgar under section 6051 for $300,000.

A central feature of the proposed regulations — both the old and the new — is potential double counting of income. Even though the IRS is quick to state that the entire proceeds will not be taxed to multiple parties, in this example, it is hard to deny the fact that there is only a total of $300,000 paid, but there is a total of $500,000 reported as having been paid. Plus, it can become especially confusing where amounts are paid as wages. Since the amount here represents wages, we know that the client will be able to claim a miscellaneous itemized deduction only for the legal fees paid to the attorney. That miscellaneous itemized deduction for $100,000 will, at least in part, be lost to a combination of the 2 percent miscellaneous itemized deduction threshold, the phaseout of deductions for high-income taxpayers, and most significantly, the AMT.

Another reason for preferring separate checks and separate Forms 1099 — where reporting is required — relates to exclusion issues. Section 104, long one of the few exclusions in the code, provides that settlement payments and damages for personal physical injuries or physical sickness are excludable from income. Up until August 20, 1996, the word "physical" was not even part of the equation, so the exclusion was significantly broader. Now, even with the "physical" modifier, there is a great deal of confusion about just how far even this restricted exclusion extends.

Since no — repeat, NO — Form 1099 is required for a payment that is excludable under section 104, plaintiffs would be well-advised not to muck up their payments by having them lumped together with attorneys' fees. Even though a defendant may believe a payment is excludable, defendants often err on the side of issuing Forms 1099 when in doubt. Payors may understandably be in a quandary about when a payment is excludable. Even the IRS has been quiet on the subject, not issuing any regulatory or ruling guidance about what the term "physical" really means. All we know — from the legislative history to the 1996 act — is that section 104 does not encompass recoveries for symptoms of emotional distress, specifically headaches, stomach aches, and insomnia. That is not much guidance.

Thus, while plaintiff's counsel may well want to urge a defendant not to issue a Form 1099 to their client on account of a section 104 exclusion, unless the case is plainly a physical injury case — such as an automobile accident — plaintiff's counsel may have to do some convincing — and may have to hire a tax lawyer — for the defendant to agree.

> Example 2 (joint payees excludable payment under section 104): Ivan Injured sues Tortco Inc. for damages for personal physical injuries. Lavonne Lawyer represents Ivan. Tortco settles the suit for $600,000 in damages excludable under section 104 from Ivan's gross income. Tortco writes the settlement check for $600,000 payable jointly to Ivan and Lavonne, and delivers the check to Lavonne. In turn, Lavonne retains $240,000 of the payment and remits the remaining $360,000 to Ivan. Tortco must file an information return with respect to Lavonne for $600,000.

> Example 3 (separate checks taxable to claimant): Terry Trademark sues Software Corporation for lost profits. Saul Solicitor represents Terry. In turn, Terry settles the suit for $300,000. Saul requests Software to write two checks, one payable to Saul in the amount of $100,000 for Saul's attorneys' fees and the other payable to Terry in the amount of $200,000. Software writes the checks in accordance with Saul's instructions, delivering both checks to Saul. Software must file an information return with respect to Saul for $100,000.

Delivery Is Not Enough

One of the concepts in the earlier proposed regulations was that delivery of a check to an attorney would be enough to trigger reporting. This is so even if the attorney was not a payee on the check. For example, the 1999 proposed regulations indicated that a check payable solely to Joe Client, but delivered to Joe Client's lawyer, Larry, would require reporting both to Joe Client and to Larry Lawyer. Comments on reporting obligations to the lawyer in this fact pattern were especially acidic.

Happily, the Treasury Department and the IRS have relented, indicating that no reporting to the lawyer will be required as long as the payment is not made to the lawyer. In the case of a payment by check, for reporting

to be triggered, the attorney must be named as either a sole, joint, or alternate payee.

Who Is a Payor?

Another suggestion that the Treasury Department followed in the newly proposed regulations concerns the definition of the term "payor." The proposed regulations adopt numerous suggestions to define this term. As a result, the proposed regulations define a "payor" as a person who makes a payment, if that person is an obligor on the payment or the obligor's insurer or guarantor.

Significantly, this is a departure from the definition of the term "payor" under section 6041. Under the basic reporting rules of section 6041, a person who makes a payment on behalf of a third person generally reports that payment only if the first person exercises management or oversight in connection with, or has a significant economic interest in, the payment. See Rev. Rul. 93-70, 1993-2 C.B. 294. In October 2000, the IRS clarified that a defendant or its insurer that pays tort damages to a claimant's attorney generally does not exercise management or oversight in connection with, or have a significant economic interest in, the payment to the attorney. Thus, a Form 1099 to the attorney in this circumstance would not be necessary under section 6041. See 65 Fed. Reg. 61292 (October 17, 2000).

Although commentators have asked that the definition of a payor for section 6041 also apply to section 6045(f), the preamble to the new proposed regulations indicate that large payments by insurers to attorneys in judgments and settlements would probably go unreported by any payor if the IRS followed this suggestion.

Interaction With Section 6041

One of the great sources of confusion about section 6045(f) is its interaction with section 6041. Section 6041(a) contains the basic 1099 rule covering most payments of $600 or more made in the course of a trade or business. Sensibly, most businesses tend to view Form 1099 rules altogether rather than piecemeal. Still, section 6045(f)(2)(B) states that section 6045(f) does not apply to any payment — or any portion thereof — that is required to be reported under sections 6041(a) or 6051.

Although presumably the idea is to avoid duplicate reporting, I have encountered significant confusion over this exception. Thus, it is worth considering the couple of alternatives that can apply to reporting in this context. Suppose a defendant's insurance company issues a settlement check for $100,000 jointly to the plaintiff and his attorney, and the insurance company knows the attorneys' fees are $40,000 of this amount. What reporting applies?

Under section 6045(f), the insurer is to report the $100,000 to the attorney. Does the exception under section 6045(f)(2)(B) apply? No, because the insurer has no section 6041 reporting obligation for the payment to the lawyer. The preamble to the new proposed regulations specifically rejects the notion that the mere fact that the plaintiff in this lawsuit may be required — under section 6041 — to report the $40,000 paid to the lawyer does not mean that the applicability of section 6041 to any part of this payment removes the applicability of section 6045(f).

Stated differently, in reviewing the interaction of sections 6045 and 6041 — each providing Form 1099 reporting in some guise — each reporting must be viewed separately. This is a significantly narrower exception than would be the case if each payment were viewed separately. A single payment, after all, may entail multiple reporting incidences. Indeed that is the hallmark of these rules: Multiple parties may be tagged with the same payment, even though being tagged may not entail reporting the payment as gross income.

A related point concerns the identity of the payees. Some commentators have suggested that if a payment, or a portion thereof, is reportable to a lawyer under section 6045(f), then it would not be subject to reporting under section 6041 with respect to another payee. See reg. section 1.6041-1(a)(1)(ii). The preamble to the new proposed regulations specifically rejects this notion. In fact, the proposed regulations amend reg. section 1.6041-1(a)(1)(ii) to explicitly limit the exception to forms issued to the same payee. The example makes it painfully clear. A person who pays $600 of taxable damages to a claimant and a claimant's attorney may be required to file an information return under section 6041 for the claimant, and another information return under section 6045(f) for the claimant's attorney.

***De Minimis* Payments**

As originally proposed in 1999, the reporting regulations had no minimum threshold. Many were therefore concerned that even small payments would have to be reported, thus increasing administrative burdens. Fortunately, the new proposed regulations adopt a $600 annual threshold per payee, bringing section 6045(f) into line with the normal $600 threshold applying under section 6041.

This rule may underscore another related but distinct topic: whether to report payments to lawyers separately or in the aggregate. For attorneys receiving a variety of payments from the same payor, it might be clearer to have separate Forms 1099. In an apparent attempt to please both those who favored aggregation and those who thought everything should be separate, the new proposed regulations provide that payors may choose to file either one Form 1099-MISC aggregating annual payments, or separate Forms 1099-MISC for each payment.

Joint or Multiple Payees

The 1999 proposed regulations dealt with reporting payments to joint or multiple payees. This is a fundamental issue. Traditionally, most settlement payments are made by joint check. How should reports be prepared when a check is made payable to several persons, each of whom presumably has his or her own taxpayer identification number (TIN)?

The so-called "delivery" rule requiring a Form 1099 even where the attorney was not a payee was scrapped. Nonetheless, in this new set of proposed regulations, the joint or multiple payee issue is far more global. Not surprisingly, the Treasury Department did not heed commentators who wanted to limit reporting to the

first named attorney on a check — as where a check is issued to multiple lawyers jointly.

Interestingly, one commentator had suggested that where there were joint or multiple payees on a check, the payor should be required to report for each attorney — denominated as an "all-payee" rule. The IRS rejected this, favoring instead what it terms the "payee-recipient" rule. Thus, if more than one attorney is listed as a payee on a check, the information return is required to be filed for the attorney who received the check. Of course, reporting may be required for the nonattorneys on the check as well under section 6041.

> Example 4 (multiple attorneys as payees): Bigco Corporation, a defendant in a lost profits case, settles a suit brought by Paula Plaintiff for $1 million, making the check payable to Paula's attorneys, Winkin, Blinkin, and Nod. The three attorneys are not related parties. Bigco delivers the check to Blinkin's office. Blinkin deposits the check proceeds into a trust account and makes payments by separate checks to Winkin of $100,000 and to Nod of $50,000 for their respective fees. Blinkin also makes a payment by check of $550,000 to Paula. Bigco must file an information return for $1 million for Blinkin. In turn, Blinkin must file information returns with respect to Winkin of $100,000 and to Nod of $50,000, if Blinkin is not otherwise required to file information returns under section 6041 for Blinkin's payments to Winkin and Nod. See prop. reg. section 1.6045-5(f), Example 5.

Exceptions for Certain Payments

One of the scope issues about section 6045(f) concerns the definition of "legal services." This is unlikely to be a big issue, since most of the action on these proposed reporting rules will be over joint payees and other multiple reporting issues. Still, there are some lines to be drawn over the definition of legal services.

Concern has been expressed, for example, whether reporting is appropriate at all where lawyers receive large payments as executors or administrators of estates, as trustees of trusts, as administrators of qualified settlement funds, as settlement attorneys in real estate transactions, etc. However, the Treasury Department has made clear that it wants broad reporting, and that these are gross proceeds reports. I guess this means not to worry, and that the mere fact that the lawyer receives a gross proceeds Form 1099 does not suggest that all of the money reported represents income to the lawyer.

Because the delivery rule has now been deleted, the preamble to these proposed regulations unabashedly says "many payors will be able to avoid reporting under section 6045(f) simply by naming the attorney's client as payee on the check, even if the check is delivered to the attorney's office." See 67 Fed. Reg. p. 35067. Virtually any payment made to a lawyer of $600 or more is therefore covered. However, no report is required under section 6045(f) for payments to nonresident alien lawyers, foreign partnerships, or foreign corporations that do not engage in trade or business in the U.S. and do not perform labor or personal services in the U.S.

Although the safe assumption may be that virtually any payment to a lawyer should be covered by the new rules, the new proposed regulations state that payments to an attorney for services that are clearly unrelated to the practice of law are not subject to section 6045(f) reporting. For example, a payment to an individual for refurbishing an antique automobile is not subject to section 6045(f), simply because that individual happens to be a lawyer.

Backup Withholding

Not surprisingly, backup withholding is a feature of the proposed reporting regulations. If an attorney does not furnish a TIN, backup withholding may be needed. Section 3406 provides backup withholding requirements. The legislative history to the 1997 act indicates that attorneys must supply their TINs or face backup withholding. Notably, where backup withholding is taken, it will be credited to the lawyer's account, not to the client's. Once again, in defense of backup withholding principles, the preamble to the new proposed regulations suggests that the elimination of the delivery rule may alleviate many of the concerns lawyers have regarding backup withholding.

Basic Reporting Obligations

Once they take effect — which, it must be stressed again, will not be until after these proposed regulations are finalized — the regulations will require persons engaged in a trade or business who make payments aggregating $600 or more during a year to a lawyer in connection with legal services to file an information return. The returns are made on Form 1099-MISC. If more than one attorney is listed as a payee on the check and the check is delivered to one of them, the return is to go to the payee attorney who received the check.

Conversely, if more than one attorney is listed as a payee on the check, but the check is delivered to a nonpayee, or to a payee on the check who is not an attorney, then the return goes only to the first listed payee attorney on the check.

The rules also outline requirements for reports by attorneys on payments made to other attorneys. If a return is required to be filed for an attorney — referred to as a "tier-one" attorney — that person who makes payments to other attorneys must report those payments as well. See prop. reg. section 1.6045-5(b)(2). The proposed regulations are clear that attorneys must furnish TINs upon request. Failure to do so will subject the attorney to backup withholding under section 3406. See prop. reg. section 1.6045-5(e).

Bifurcate Payments!

For a whole variety of reasons, these proposed regulations provide additional incentives for separately paying amounts to lawyers and their clients. Unless there is good reason to do something else, issuing separate payments to lawyer and client should now be the norm. When drafting settlement agreements, specific figures should be inserted calling for separate payments.

Apart from calling for separate payments, it is always a good idea to specifically state what tax reporting will be made for all payments in a settlement agreement. On all too many occasions, plaintiffs and defendants do not think about this, and long after a settlement agreement is signed — typically early in the following year when Forms W-2 and 1099 are prepared — disputes arise. Especially now where duplicate reporting may be contemplated, it is simply good business to have plaintiff and defendant set forth their expectations so that tax reporting becomes a part of the settlement agreement. The time to resolve disputes about interpretations of the tax reporting rules is before the settlement agreement is signed, not after.

Occasionally, plaintiff's counsel voice objections to disclosing to the paying defendant their contingent fee arrangement, and the exact amount that lawyer and client will each receive. The objections to such disclosure usually voiced by plaintiff's counsel include: (a) concern about public disclosure of their fee arrangement; (b) concern about multiple plaintiffs or multiple defendants who may be subject to different treatment; and even (c) simple difficulty in gathering and itemizing all costs and disbursements attributable to a case before the settlement documents, with disbursement figures, have to be finalized.

Assuming one can get over these objections, separate checks for every case ought to be the rule rather than the exception. Although the elimination of the dreaded delivery rule makes these proposed regulations more user-friendly than the last set, some continued wrangling by lawyers can be expected.

Robert W. Wood practices law with Robert W. Wood, P.C., in San Francisco (info at www.robertwwood.com). He is the author of 28 books, including *Taxation of Damage Awards and Settlement Payments* (2d Ed. © 1998), published by Tax Institute (e-mail info@taxinstitute.com), and available at Amazon.com.