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## RESOLVE TAX TREATMENT BEFORE SETTLEMENT AGREEMENT IS SIGNED

by Robert W. Wood

If you receive payment from a client, will you receive an IRS 1099 Form? What if an opposing party pays your fee? What if the check is not only for your fees, but also to settle a lawsuit brought by your client? Will you receive a 1099 for the full amount? Will your client get a 1099 Form too?

The answer to all these questions — at least apparently — is yes. But you can influence what tax forms are filed by how you have checks prepared. First, some background.

The IRS issued proposed regulations in 1999 (see 64 Fed. Reg. 27730) that contemplate duplicate 1099 reporting (both to lawyer and client) on the same dollars. A \$100,000 settlement 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. After vocal criticism, the IRS announced in Notice 99-53 that the effective date would be delayed for one year.

After two more delays, the other shoe has finally fallen, with the publication of new proposed regulations on May 17, 2002. See Vol. 67, Fed. Reg. No. 96, p. 35064 (May 17, 2002). These rules will apply only to payments made two months after the date of publication of the final regulations in the Federal Register.

### Duplicate Reporting?

Unfortunately, the new 2002 proposed regulations made clear that double counting is still possible. In the classic joint payee check settlement of a case, unless the payor has knowledge of who is ultimately getting what, duplicate 1099s (to lawyer and client) will be required. The IRS has explained that the payment to the lawyer will be a “gross proceeds” 1099. According to the IRS, the “gross proceeds” designation merely means that the attorney was provided funds in that amount, not that it is all income.

Still, most attorneys will want to avoid the mismatching of the 1099s with the amounts shown as gross income on their tax returns. Most attorneys receiving gross proceeds Forms 1099 will 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 the lawyer's own portion of that check) — may give the lawyer a more accurate picture of his gross income. However, there is still a risk of a mismatching, since the IRS tracks Forms 1099 with tax returns.

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 and client.

Example 1 (joint payees): Edgar Employee, who is represented by AI 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 AI for \$200,000, net of income and FICA tax withholding. Dastardly delivers the check to AI. AI 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 1099, though the proposed regulations do not specify) to AI for \$200,000. Dastardly must also issue a Form 1099 to Edgar under Section 6051 for \$300,000.

Contrast this to the use of separate checks.

Example 2 (separate checks taxable to claimant): Terry Trademark sues Software Corporation for lost profits. Terry is represented by Saul Solicitor. 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.

On double-counting of income, even though the IRS is quick to state that the entire proceeds will not be taxed to multiple parties, it is hard to deny the fact that here there is only a total of \$300,000 paid, but there is a total of \$500,000 reported as having been paid. It can become especially confusing where amounts are paid which represent wages.

Another reason for preferring separate checks and separate 1099s (where reporting is required) relates to exclusion issues. Section 104 of the Internal Revenue 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, when in doubt, defendants often err on the side of issuing Forms 1099. Payors may understandably be in a quandary about when a payment is excludable and when it is not. Even the IRS has been awfully 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 headaches, stomach disorders and insomnia. That’s 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.

#### Multiple Payees

One of the underpinnings of the 1999 proposed regulations was dealing with reporting payments to joint or multiple payees. How should reports be prepared when a check is made payable to several persons?

If more than one attorney is listed as a payee on a check, the information return is required to be filed with respect to the attorney who received the check. Of course, reporting may be required for the non-attorneys on the check as well under Section 6041.

Example 3 (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. Winkin, Blinkin and Nod 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 Not of \$50,000 for their respective attorneys’ fees. Blinkin also makes a payment by check of \$550,000 to Paula. Bigco must file an information return for \$1 million with respect to Blinkin. Blinkin, in turn, must file information returns with respect to Winkin of \$100,000 and to Nod of \$50,000.

#### Bifurcate Payments!

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. The proposed regulations are clear that attorneys must furnish taxpayer identification numbers upon request. Failure to do so will subject the attorney to backup withholding under Section 3406. See Prop. Reg. §1.6045-5(e).

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. Plaintiffs and defendants often don't 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. 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 norm.

***Resolve Tax Treatment Before Settlement Agreement is Signed***, San Francisco Daily Journal (July 30, 2002), p. 5.