



Lawyers, Settlements, and Forms 1099-MISC and 1099-NEC

by Robert W. Wood



Robert W. Wood

Robert W. Wood practices law with Wood LLP and is the author of *Taxation of Damage Awards and Settlement Payments* and other books available at www.TaxInstitute.com.

In this article, Wood explains several kinds of Forms 1099 and how they factor into drafting and negotiating settlement agreements.

Copyright 2020 Robert W. Wood.
All rights reserved.

If you are a plaintiff or a contingent fee lawyer, you might not think about taxes when you are settling your case and looking forward to getting some cash. Plaintiffs are more likely to think about taxes than defendants, but even plaintiffs don't always think about taxes until later. Everyone thinks about taxes around January 31 each year — the date by which all those small but mighty IRS Forms 1099 are supposed to arrive in the mail.

Errors and Non-Errors on Form 1099

In most cases, Forms 1099 report income. If you receive a Form 1099, 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. One exception is the Forms 1099 that report gross proceeds to lawyers, discussed more later. If you believe the form is wrong, you may be able to get the issuer to correct or undo it. But that's usually tough unless it's truly an error.

Suppose you receive a Form 1099 that says a company paid you \$100,000, but you can prove that the company paid you only \$10,000. You hope it would correct that error. If you cannot get the

company to correct it, you must report the \$100,000 and explain that you actually received only \$10,000. Unfortunately, most "please fix my Form 1099" requests fall on deaf ears. Often that is because the issuer of the form believes it issued the form correctly, and it is often right.

Also, many Form 1099 reporting issues that seem like errors aren't. Suppose you are a plaintiff and net \$60,000 when your lawyer collected \$40,000, a 40 percent contingent fee. You will usually receive a Form 1099 for the full \$100,000. 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.

Forms 1099 allow computer matching of Social Security numbers and dollar amounts paid and received, so IRS collection efforts are streamlined and automated. 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 will 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 emotional distress. Even if it is certain that you will receive a Form 1099, there are different boxes on the forms that signal different things 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? Isn't one box on a Form 1099 as good as another? Not really, as we'll see.

Forms 1099-MISC and 1099-NEC

Worry about Forms 1099 causes some clients and some 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 Form 1099 boxes 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.

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, 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 with box 7.

Because of the self-employment tax, most payees would rather receive amounts reported in box 3 compared with box 7. Sometimes you can specify (such as in a legal settlement agreement); otherwise the payer of the money generally picks whatever reporting she thinks is best. For payments in 2020 and later years, the IRS has a special form for independent contractors. Maybe the gig economy finally got to the IRS.

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. I'm guessing that in early 2021, there could be considerable confusion about Form 1099-NEC, and there might even be some disputes. What happened to Form 1099-MISC now that box 7 was essentially made into a whole new tax form?

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, and it still exists (box 14 for 2019 and prior years, and box 10 of the new 2020 Form 1099-MISC). This box is only for payments to lawyers, and there are numerous special Form 1099 rules for lawyers.

Gross Proceeds Paid to an Attorney

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. Some accountants will report the full \$1 million as income and then deduct the \$600,000 paid to the client. Technically, though, the lawyer need not report the full \$1 million as income because it is not. The lawyer can simply report as income the \$400,000 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 if and how to deduct the \$400,000 in legal fees.

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 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 or more for services must report it on a Form 1099. The rule is cumulative, so while one payment of \$500 wouldn't 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 even co-counsel when services are performed and the payment is \$600 or more.

A notable exception to this \$600 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 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 in a year as part of the client's business must issue a Form 1099.

Of course, 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

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. Compensatory damages for personal physical injuries, of course, should not be the subject of a Form 1099.

However, even for payments that are clearly taxable to the plaintiff, there is rarely a Form 1099 obligation on the part of the plaintiff's own lawyer to issue a Form 1099 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. The so-called middleman regulations are complex, but just being a plaintiff's lawyer and handling settlement money is not enough to require the lawyer to issue a Form 1099 for the payment.

Forms 1099 From Lawyers to Clients

If a plaintiff's attorney issues a Form 1099 to the client, the client could end up getting two different Forms 1099 for the same settlement payment: one from the defendant and a second from his own attorney. That can complicate the

client's tax reporting and create unnecessary stress. Thus, a contingent fee attorney should query whether they are actually required to issue a Form 1099 to a plaintiff client before issuing one.

Some attorneys believe they need to issue a Form 1099 to a client to be able to deduct the client's portion of the recovery from the attorneys' income. However, an attorney generally isn't required to include their client's portion of the recovery in their gross income in the first place (even if it is reported to the attorney as "gross proceeds" on a Form 1099). In fact, the attorney is normally only required to report in gross income the portion of the recovery that constitutes the attorney's legal fees. A Form 1099 to the client usually isn't required under the Form 1099 regulations, nor is it required to ensure that the lawyer isn't paying tax on the client's portion of the recovery.

Is a Form 1099 required for client refunds? That is a different question from the usual contingent fee recovery situation. If the refund is of money held in the lawyer's trust account, no Form 1099 is required. However, if the law firm was previously paid and is refunding an amount from the law firm's own income, a Form 1099 is appropriate.

Form 1099 Penalties

Our breezy tour of select reporting issues wouldn't be complete without a brief mention of penalties, even though they are generally small. Form 1099 rules take up hundreds of pages in the IRS regulations, and they are complex and sometimes even conflict with one another. The complexity of the rules probably causes many businesses, and some law firms, to err on the side of issuing the forms. An IRS penalty for *issuing* an unnecessary Form 1099 is probably hard to imagine, so the tendency to think, "when in doubt, issue the Form 1099," is easy to understand.

Of course, recipients may not like this, and lawsuits for issuing Forms 1099 are filed on occasion. Most such suits don't seem to go very far, perhaps precisely because it is often possible to justify whatever was issued. But what happens if you were clearly supposed to issue a form, but you don't? Most penalties for unintentional

failures to file the forms are modest — as small as \$270 for each form not filed.

Even then, you may be able to avoid a penalty by showing that you had reasonable cause for what you did. An often-cited technical danger (but generally not a serious risk as a practical matter) is the penalty for intentional violations. If a taxpayer *knows* that a Form 1099 is required to be issued and nevertheless doesn't issue it, the IRS can impose a penalty equal to 10 percent of the payment. My guess is that the situation has to be pretty clear for this penalty to be assessed and collected.

Personally, I have never seen this intentional disregard penalty proposed by the IRS, much less collected. However, some defendants worry about it when deciding whether they should sign a settlement agreement committing not to issue a Form 1099 in a disputed case involving a claimed exclusion under section 104. But if there is good-faith bargaining going on over settlement wording and Form 1099 treatment, that could already be enough to take the payer away from the vicinity of the intentional disregard penalty.

Requests for IRS Form W-9

Any Form 1099 requires taxpayer identification numbers, so attorneys are commonly asked to supply payers with their law firm's ID number and those of their clients. Usually, the request is to sign and return a Form W-9. Should lawyers and clients agree? Usually, if they don't the money simply will not be paid.

A plaintiff in a physical injury case who has just secured the agreement of the defendant not to issue him a Form 1099 will wonder why supply a Form W-9? The purpose of the Form W-9 is to provide and verify the taxpayer's Social Security number. Doesn't that mean the defendant will — or might — issue a Form 1099 after all?

Not really, it may just mean that this defendant won't pay much of anything to anyone without a signed form. In addition to supplying a payee's Social Security number, the Form W-9 certifies that the recipient is a U.S. person (that is, a U.S. citizen or tax resident), and therefore not subject to the onerous reporting and withholding obligations often required for "outbound" payments to non-U.S. persons. Thus, many companies have a policy of requiring signed

Forms W-9 for any payment so they can prove they didn't have to worry about the special rules for outbound payments.

It doesn't appear to be commonly invoked, but there is also a potential penalty for refusing to provide a signed Form W-9 if requested. If a payee is requested to provide a taxpayer ID number and fails to provide it to a paying party, he is subject to a \$50 penalty for each failure to supply that information. A more effective remedy is likely to be the threat of backup withholding. A payee providing false or inaccurate information, or refusing to hand over a Form W-9 when requested, is subject to backup withholding on the payments.

In any case, when a payer requires a Form W-9, it is usually not worth fighting about providing it, as long as there is already an understanding about which Forms 1099 will be issued. And if it turns out that the payee is not a U.S. person, so cannot sign a Form W-9, a Form W-8BEN is the counterpart form for non-U.S. persons that should also satisfy the payee.

Conclusion

IRS Forms 1099 are ubiquitous, a kind of everyman's tax form. There are many kinds affecting interest, retirement accounts, tax refunds, and more. We have only scratched the surface here regarding forms 1099-MISC and 1099-NEC. Pay attention to the forms not only at tax time but also when drafting and negotiating settlement agreements, and especially when the forms arrive in the mail. ■

taxnotes®

Federal | State | International



**Want to be renowned
in the tax community?**
Write for Tax Notes.

If you do, you will:

- ▶ Receive exposure in the world's leading tax publication
- ▶ Join a network of the best and brightest minds in tax

taxnotes.com/acquisitions

Your byline here.