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Five simple tax rules for lawyers (and everyone else)

By Robert W. Wood

We all have to pay taxes and no one wants any trouble. Follow these rules and you'll reduce your chances of coming to grief from the Internal Revenue Service—in your practice and in your personal life.

Keep good records. You might think good records will help you only if you're audited. Actually, keeping good records can keep you out of trouble in the first place. Most audits are by correspondence. For example, you might be told that your deductions will be disallowed unless you produce records substantiating them.

Often this kind of query will escalate if you don't handle it properly. You can't use queries of this nature to *start* keeping records. It simply doesn't work and the truth will come out. To respond quickly and thoroughly, be prepared.

Respect Forms 1099 and information matching. Much of what the IRS does is information return matching. It is an endless process of correlating taxpayer identification numbers and payments, including Forms W-2, 1099 and K-1. Even small mismatches will be caught and can trigger bigger problems.

Mistakes involving Forms 1099 are most common. There are different Forms 1099 for miscellaneous income (1099-MISC), interest (1099-INT), and more. Lawyers and law firms should know how and when to issue them as well as receive them. Usually you need not issue the forms to clients.

You need a system to record and track 1099s—that's exactly what the IRS does. How you handle these forms year-round matters. When you or your firm receive Forms 1099 and other information returns, don't just stick them in a drawer. Examine all of these items promptly.

If you receive an incorrect Form 1099 (as is common), contact the payor that issued it. Explain the error and ask if they have already sent a copy to the IRS. If they have, ask for a "corrected" 1099 (there's a special box for this).

Always consider timing. Just about everything in taxes is about timing. Timing affects when you have income as well as when you can claim deductions too. Lawyers often have trouble with this issue, especially with the income side.

If you have signed a settlement agreement and payment comes to your trust account you have *actual receipt*, and that means income. But even *constructive receipt* represents income. The classic constructive receipt example is where you push away a paycheck and say "pay me later." For tax purposes, however, it is income now.

Thus, if you sign a settlement agreement and belatedly tell the defendant to pay the money next year instead, you still have the income this year. The reason: You were legally entitled to it. It's the same rule if you sign papers selling your house and then notify the seller you want the sales price next year rather than immediately. Again, you have constructive receipt of the money this year.

But suppose that you had originally contracted for a legal settlement paid in installments over several years? There is no constructive receipt. You are entitled to contract for payment in a particular way as long as you have note signed the documents. Similarly, if you sold your house now calling for the purchase price to be paid to you in January, that will be respected as long as it is in the original contract.

Be careful with your trust account. Good accounting and good taxes go together. When it audits lawyers, the IRS often turns to lawyer trust accounts. So apart from any state bar rules, be careful.

When you receive a settlement in your trust account that is 40% yours and 60% your clients, you have income and so does your client. This is so even if you don't distribute the funds until the next year. Where you are holding funds for a client for some time, also consider how the interest is taxed.

With your standard IOLTA account, the State Bar gets the interest and you aren't taxed on it. But if you set up special purpose trust accounts, you'll need to give a Taxpayer ID number and someone will receive a Form 1099. If you and the client agree who is taxed, use that Taxpayer ID number.

Speaking of bank accounts, if you have any foreign accounts (in your practice or personally) ensure that you comply with the IRS rules. You must report worldwide income on your U.S. tax return whether or not you receive a Form 1099. Foreign banks don't send them.

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Plus, whether the money is yours beneficially or you are a mere signatory (like at trust account), if the aggregate of all foreign accounts is more than $10,000 at any time during the year, you must file a Report of Foreign Bank Account, commonly called an FBAR. Penalties are serious, even including potential criminal liability.

Keep business and personal separate. What constitutes a deductible business expense is surprisingly fluid. One of the most classic requirements is that it be ordinary and necessary, but that's less rigorous than it sounds. Yet you can keep some of your tax worries away by not being too inventive when it comes to tax deductions.

In particular, before you spend—and certainly before you deduct—consider what advances your business and is 100 percent business-related. You may do things with a dual motive like a pleasant lunch with a business colleague, a boondoggle with your best client or buying a vacation home you also intend as an investment. But your tax life will be easier if you avoid morphing personal into business.

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