More Confusion Over 1099s

By Robert W. Wood

Tax professionals and an increasing number of litigators are understandably concerned about the reporting requirements embodied in Forms 1099. When a case settles or goes to judgment, who should get Forms 1099 and in what amounts? Once the lawyer has the money and it comes via a joint check payable to the lawyer and client, how should the lawyer deal with it? Should the plaintiff's lawyer issue a Form 1099 to the client?

There are many more questions that can be asked about this subject, but at least a few answers can be given in this brief article. I will review and discuss some of the current issues surrounding these not so new — but now terribly important — questions.

1997 Law Change

In 1997, Congress enacted section 6045(f). It requires that most payments to attorneys now must be subject of a Form 1099. In the old days, sole proprietor attorneys had to receive 1099s, but partnerships and corporations did not. Now, regardless of the form in which the law firm (or lawyer) does business (yes, even professional corporations, partnerships and LLPs), a Form 1099 generally must be *sent by the client* to the lawyer.

This law took effect on January 1, 1998, so most of these Forms 1099 did not start showing up on the desks of attorneys until January 1999. The general requirement for 1099s and W-2s is that they must be sent to the taxpayer no later than January 31 of the year following the year the payment is made. Then, they send a Form 1096 transmittal form to the IRS no later then the end of February. Effectively, there is a one-month lag. Presumably, one reason for the one-month delay is so taxpayers can try to have any mistakes quickly corrected.

The requirement in section 6045(f) that lawyers should receive a Form 1099 is not controversial. It is a well-established principle that attorneys should pay their taxes just like everyone else. Further, the IRS long ago made clear that it would focus on the legal profession since it was believed that attorneys as a group were likely to underreport income. For many years there was a special IRS investigation dubbed "Project Esquire" to ferret out lawyers who either underreported or completely failed to file returns. In some instances, criminal charges were filed.

Client Payments

The most controversial aspect of section 6045(f) concerns payments to or for clients. Since 1998, the IRS has proposed two separate sets of regulations to deal with this particular issue. However, neither set of proposed regulations has been finalized. The IRS finally relented in January 2001 and indicated the regulations would not be effective until they were finalized. Yet, many law firms and companies seem to be treating these proposed regulations as gospel already:

Question: What happens when a check is cut to a lawyer and client jointly (as often happens in contingent fee litigation); who should get the 1099?

Answer: The general IRS answer to this question in both sets of proposed regulations (and it remains the IRS view to this day) is that the client and the lawyer should *each* receive a Form 1099 for the entire amount of the payment. Understandably, clients and lawyers are concerned about "double counting" of income. There are ways that the both sets of proposed regulations had tried to deal with this concern.

One of the ways to diffuse this bomb was if the lawyer divulges in the beginning the exact allocation to the defendant who is disbursing the amounts. As an example, the lawyer will get $40,000 in fees and the client will get $60,000 as a settlement out of a total payment of $100,000 from the defendant. Here, the lawyer just wants to receive a Form 1099 for $40,000, and the client wants to receive one for $60,000. The proposed regulations make clear that the lawyer would still get a 1099 for $40,000, while the client should receive a 1099 for the entire $100,000.

If your blood does not start to boil yet, then consider some of the lesser-known provisions of the proposed regulations. One provision would require a defendant to issue a Form 1099 to both the lawyer and the client — each for the full amount — if a check made payable solely to the client was merely delivered to lawyer's office. For example, if the case settles for $100,000, the check is made payable solely to the plaintiff — let's say the lawyer was doing this case pro bono or on an hourly basis — the IRS's view was that the defendant should issue a Form 1099 for $100,000 to the lawyer and $100,000 to the plaintiff!

Regulations Delayed

The proposed regulations in both sets were sufficiently controversial that the IRS reversed itself on the implementation even though it had originally announced that these rules would take effect for payments on or after January 1, 2001. The IRS announced in early 2001 that the new rules would not become effective until final regulations were published in the *Federal Register.* A good part of 2001 has already passed, and no final regulations have been released. It is not clear when that will happen, or even whether it will happen this year.

Until then, many law firms and companies are using the second set of proposed regulations as the litmus test for what the IRS will probably expect. Many are therefore issuing Forms 1099 like mad. Yet, the final regulations have simply not been published and many of these companies are, I feel, being overly cautious.

Alternative Minimum Tax Problem

Most readers know that one of the main reasons all of this matters a great deal is that increasingly, with the ever-shrinking IRS audit program, a principal technique for generating audits is through an identification of mismatches between Forms 1099 and reported income. Consequently, Forms 1099 have become very, very important.

Especially in the litigation context, which frequently involves large sums of money, there can be a dramatic difference between the tax result to the plaintiff if that person receives and reports only the net amount recovered after attorneys' fees and costs or reports the entire gross amount of the recovery and then deducts the attorneys' fees and costs. Reasons for the difference in tax result include the 2 percent miscellaneous itemized deduction rule and the phaseout of exemptions and deductions for high-income persons. Another factor, though, is the alternative minimum tax (AMT), which can reduce or eliminate outright attorneys' fee deductions.

'Netting'

Well, is the plaintiff taxable on the gross amount of a recovery and must that person run the gauntlet of these various limitations on the deductions for attorneys' fees, or can the plaintiff merely report the net? That turns out to be a very sticky question. A bitter split on the appellate level is being fought on that very question. One could easily consume 50 pages about all of the cases that have considered this issue, and how they come down, in some cases primarily based on what state law says about attorneys' fees and attorneys' liens. With a bit of oversimplification, the case law right now breaks down as follows:

1. Circuits permitting netting of attorneys' fees, so that the plaintiff would have to report in a properly structured deal only the net amount he receives, include the Fifth, Eleventh, and Sixth Circuits. See *Cotnam v. Commissioner,* 236 F.2d 119 (5th Cir. 1959), *rev'g in part and aff'g in part* 28 T.C. 947 (1957), *95 TNT 38-83; Willie Mae Barlow Davis v. Commissioner,* 210 F.3d 1346 (11th Cir. 2000), *Doc 2000-12246 (5 original pages), 2000 TNT 86-7; Estate of Arthur L. Clarks v. United States,* 202 F.3d 854 (6th Cir. 2000), *Doc 2000-1776 (7 original pages), 2000 TNT 10-21;* and *Sudhir P. Srivastava v. Commissioner,* 220 F.3d 353 (5th Cir 2000), *Doc 2000-20090 (16 original pages), 2000 TNT 145-9.*

2. Circuits in which the plaintiff must include the entire gross amount of the settlement — even if the plaintiff is never allowed to touch the amount the plaintiff's attorney gets — include the Ninth, First, and Federal Circuits. See *Kenneth Alexander, et ux. v. Commissioner,* 72 F.3d 938 (1st Cir. 1995), *Doc 96-602 (21 pages), 96 TNT 1-74*; *Jack L. Baylin v. United States,* 43 F.3d 1451 (Fed. Cir. 1995), *Doc 95-342, 95 TNT 4-23; Ivor F. Benci-Woodward, et ux., et al. v. Commissioner,* 219 F.3d 941 (9th Cir. 2000), *Doc 2000-20007 (7 original pages), 2000 TNT 144-8;* and *Franklin P. Coady v. Commissioner,* 213 F.2d 1187 (9th Cir. 2000), *Doc 2000-16766 (7 original pages), 2000 TNT 117-9.*

3. Circuits not yet having ruled on the issue include the Seventh (although a case is now pending on this topic in the Seventh Circuit), Second, Third, Fourth, Tenth, and D.C. Circuits.

Supreme Court or Congress?

I am not sure who will be the ultimate "fixer" of this problem. The Supreme Court ought to resolve this severe split on the appellate level. Strangely, though, the Supreme Court recently turned down a request for *certiorari* in a Ninth Circuit case, *Coady v. Commissioner.*

One can hope that the Supreme Court will take up this issue at some later date.

Otherwise, Congress should deal with the topic. There is great momentum to repeal the AMT that would alleviate most of this problem. Unfortunately, the massive tax bill recently signed by President George W. Bush on June 7, 2001 — the "Economic Growth and Tax Relief Reconciliation Act of 2001" — took so much energy and money that an outright repeal of the individual AMT right now seems unlikely. Time will tell how this gets fixed.

Form 1099 Penalties

Although penalties for failure to file Form 1099 have not been addressed, it is worth a brief mention. The basic penalty for failure to file a Form 1099 is $50 per failure (and it doesn't even reach the $50 level until the form itself is a few months late). This charge is a penalty designed to make an impact only with multiple or mass failures. For example, in the event that a class action with 25,000 members that does not receive Forms 1099, the $50 per failure penalty adds up.

Moreover, in the case of willful failures to file Form 1099, the penalty is 10 percent of the amount involved. If a Form 1099 should have been sent out — even to one individual — for $10 million, that means the penalty would be $1 million. This penalty obviously has the potential for large charges and has been often cited as support for the argument that a Form 1099 that is probably unnecessary should be issued out of sheer caution. However, in 22 years of practice, I have never seen the "intentional" failure to 1099 penalty asserted by the IRS, much less collected. Thus, if tax counsel is involved in bargaining over the reporting, issuing tax opinions, etc., I find it hard to imagine the willfulness penalty being imposed. My experience, at least, bears this out. The willful failure to file penalty is severe, and lawyers and accountants ought to at least be aware of its existence. However, as a practical matter, it does not seem likely to be a problem in most cases.

Wage Withholding Issues

It is worth mentioning that even before the question of Form 1099 reporting is considered, in some types of litigation — such as employment litigation — the question of whether an amount constitutes "wages" subject to withholding must be considered. This topic merits a separate article. For one thing, unlike penalties generally applicable for failure to file Forms 1099, penalties for failures to withhold on wages are quite severe. Consequently, in employment litigation, tax counsel should be engaged to determine what amount, if any, represents wages subject to withholding. Not only may the defendant-payor have withholding responsibilities, but also in some cases the lawyers who receive a gross check on which withholding should have been taken will have that withholding responsibility themselves.

Conclusion

The reporting aspects of settlements and judgments have become more complex and the stakes have risen even higher over the last two years. And it is clearly going to get worse once the IRS finalizes its regulations. On top of everything else, plaintiffs and defendants are becoming more sophisticated about tax matters. As a result, I have seen clients with an increasing tendency to bring malpractice actions against attorneys or other professionals for failing to bring tax issues to their attention.

So, if the IRS does not get you for failing to comply with their rules, sometimes, your client may have his or her own complaints. If the tax issues do not get thoroughly addressed and documented in the settlement agreement, it is likely that the IRS, your client, or both may come calling when the Forms 1099 are disseminated in the following year.

Robert W. Wood practices law with Robert W. Wood, P.C., in San Francisco (info at www.robertwwood.com).