

NEW PROPOSED FORM 1099 REGS: LAWYERS AND OTHERS TAKE NOTE

by Robert W. Wood¹

There has been a great deal of sound and fury over the past few years about Form 1099 reporting. In 1997, when Section 6045(f) was enacted, various lawyer groups were up in arms about that section's requirement to issue Forms 1099 to lawyers on their fees. But the real fireworks started when the Treasury Department published proposed regulations that made the reporting of payments to lawyers (and their clients) confusing, complicated and in some cases downright overreaching. The proposed regulations were eventually suspended, so it is not clear at this moment exactly what will happen next. The suspension only lasts until January 1, 2001, at or after which time it is assumed the Treasury Department will release a new version of the proposed regulations.

Attorneys and 1099 Controversy

The controversy over 1099s and lawyers really began (or at least was thrust into prominence) with the enactment of Internal Revenue Code Section 6045(f), added by the inaptly-named Taxpayer Relief Act of 1997. This imposed a number of new burdens on reporting entities, and ostensibly puts new burdens on payors and recipients of attorneys' fees. Section 6045(f) may not have been widely noticed in 1997, and in any case did not take effect until payments commencing in 1998. In fact, it was not until the beginning of 1999, when Form 1099 reports were prepared for the 1998 tax year, that people began to really sit up and take notice.

Then, in May of 1999 the IRS announced a notice of proposed rule making and issued proposed regulations in the Federal Register (64 Fed. Reg. 2770). The proposed regulations were also published in the Internal Revenue Bulletin (1999-23 I.R.B. 14). The comments were voluminous, and there was a great hue and cry by various bar organizations about the onerous and unfair obligations these proposed rules put on lawyers, and the onerous and unfair tax results that might apply to their clients. As a result, the IRS announced in Notice 99-53, 1999-46 I.R.B. 1 (Oct. 27, 1999), that the effective date for the proposed attorney reporting regs would be delayed for one year. These regulations (REG-105312-98) are not scheduled to be effective until they are finalized, and then are to apply to payments made after December 31, 2000. That provides at least some measure of breathing room.

Not So Fast...

But now there is concern with a new set of proposed regulations, just issued this October, that also speak to the question of attorney fee reporting. All this is of significant moment when you consider the importance of reporting as part of the IRS' current enforcement mechanism. Information matching requires little manpower and enables the IRS to have an effective and efficient means of tracking payments and receipts. In virtually every lawsuit settlement now, the topic of exactly who is going to get a Form 1099 and for how much should be discussed. Generally, this discussion should then be embodied in the settlement agreement itself. This is good practice and avoids surprises for plaintiffs, defendants and their lawyers.

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To make matters slightly more complicated, the IRS has just revisited their long-standing regulations that were published way back in 1984 under more general Form 1099 topics (not limited to lawyers), and issued a new set of proposed regulations. See REG-246249-96, published in 65 Fed. Reg. 61292-61299 (Oct. 17, 2000). They can also be found at Tax Analysts Doc. No. 2000-26882.

These proposed regulations are scheduled for a public hearing in Washington on February 7, 2001 at 10:00 a.m. at the main IRS building. Written comments on the proposed regs are due to the IRS by January 17. They are not to be effective until the beginning of the calendar year following the publication of these regulations as final regulations in the Federal Register. In other words, the regulations have to go through the hearing process, and will presumably either be changed or finalized in this form, but there will certainly be some delay before they are finalized. Only then will they be effective.

Focus on Intermediaries

There are various aspects of the proposed regulations that are worth noting. They clarify who the payee is (seemingly a simple topic) for information reporting purposes when a check or instrument is made payable to joint payees. This has been a constant problem for lawyers and their clients, since settling cases by a joint check payable to lawyer and client is so common. These proposed regulations also address the topic of requirements for escrow agents and other persons who make payments for another person.

One of the provisions, as noted, concerns payments to joint payees. When a payment is made to joint payees, the proposed regulations provide that the payment may be fixed and determinable income to one payee, even though it is not so classified to the other. For example, when a payment in consideration for services is made payable to joint payees, one of whom is the service provider, a Form 1099 must be made showing the service provider as the payee.

Perhaps one of the most important changes is that the proposed regulations deal with the concepts of payments made for another person. They use the concept of management or oversight functions as a benchmark. As proposed, a person who makes a payment for another person and performs a management or oversight function in connection with (or has a significant interest in) the payment, must report it. A significant economic interest is an interest that would be compromised if the payment was not made. Real estate agents who manage rental property and make payments to landlords, for example, would be considered payors, and would still be subject to the rules.

Several types of payors are removed from what was a list of exemptions. Notable among these groups (that now are subject to return filing requirements) are payments that a bank or similar institution collects and pays over (or credits to the account of) the actual owner of the funds. Likewise, the proposed regulations would remove investment advisors from the list of exempt recipients.

Lawyers and Fees

This set of proposed regulations is not directed primarily or explicitly at attorneys, unlike the proposed and delayed Section 6045(f) regulations. Nevertheless, that these rules do have application to attorneys is made clear by the language of the proposed regulations, and even by several examples. Consider the following:

Example: AI Attorney deposits into a client trust fund a settlement payment from Dan, the defendant in a breach of contract action for lost profits in which AI represented plaintiff Pauline. AI makes

payments from the client trust fund to service providers such as expert witnesses and private investigators for expenses incurred in the litigation. Al decides whom to hire, negotiates the amount of payment, and determines that the services have been satisfactorily performed. In the event of a dispute with a service provider, Al withholds payment until the dispute is settled. With respect to payments to the service providers, Al is performing management or oversight functions and is subject to the information reporting requirements of Section 6041. Prop. Reg. §1.6041-1(e)(3), Example 7.

Consider this example too:

Example: Assume the same facts as in the previous Example, except that after paying the service providers and deducting his legal fees, Al pays Pauline the remaining funds that Al had received from the settlement with Dan. With respect to the payment to Pauline, Al is not performing management or oversight functions and does not have a significant economic interest in the payment, and is not subject to the information reporting requirements of Section 6041. For the rules relating to Dan's obligation to report the payment of the settlement proceeds to Al, see Section 6045(f) and Section 1.6045-5. For the rules relating to Dan's obligation to report payment of the settlement proceeds to Pauline, see paragraphs (a)(1)(i) and (f) of this section. For the rules relating to Pauline's obligation to report the payment of attorneys' fees to Al, see paragraphs (a)(1)(i) and (b)(2) of this section. Prop. Reg. §1.6041-1(e)(3), Example 8.

Several facts about these examples should be noted. In the first example, where the attorney is providing oversight and management functions (which would be typical for an attorney to provide), the attorney is subject to Form 1099 requirements. This means that the attorney is considered a payor with respect to all of these payments. Thus, Forms 1099 must be sent.

Second, where the attorney is not providing oversight and management functions and does not have a significant economic interest in the payment, he is not subject to the information reporting rules. All that means is that the attorney is not required to issue Forms 1099 (at least under this provision) with respect to the experts and consultants. Of course, the example says that for rules relating to the defendant's obligation to report the payment of the settlement proceeds to the lawyer, see Section 6045(f) and the regulations under that provision.

Recall that these are the rules that were hotly debated and upon which we are now awaiting a second set of proposed regulations (no earlier than January 2001). (On this topic, see the beginning of this article.) Since Section 6045(f) still stands in the Code and seems to require payments to attorneys to be the subject of a Form 1099, attorneys are already receiving those Forms 1099 notwithstanding the lack of regulations. Finally, this example says that for rules relating to the defendant's obligation, to report the payment of the settlement proceeds to the plaintiff, see paragraphs (a)(1)(i) and (f) of the section. Even the plaintiff may have to report payments to the plaintiff's lawyer!

One of those provisions, in turn, is explicit about attorneys' fees. Section 1.6041-1(f) of the proposed regulations provides that the amount to be reported as paid to a payee is the gross amount of the payment before fees, commissions, expenses or other amounts owed by the payee to another person have been deducted, whether the payment is made jointly or separately to the payee and the other person. The examples that are used make clear exactly what the Service has in mind.

Example 1: Attorney Al represents Paul Plaintiff in a breach of contract action for lost profits against Defendant Dan. Dan settles the case for \$100,000 damages and \$40,000 attorneys' fees. Dan issues a check payable to Al and Paul in the amount of \$140,000. Dan is required to make an

information return reporting a payment to Paul in the amount of \$140,000. Prop. Reg. §1.6041-1(f)(2), Example 1.

Example 2: Assume the same facts as in Example 1, except that Dan issues a check to Paul for \$100,000 and a separate check to Al for \$40,000. Dan is required to make an information return reporting a payment to Paul in the amount of \$140,000. Prop. Reg. §1.6041-1(f)(2), Example 2.

To be sure, the proposed regulations are clear that they are not to take effect until they are first published as final regulations, and that can only occur after the hearing process. At the same time, it may be very troubling to attorneys to find that in a set of proposed regulations that do not appear to affect attorneys, attorneys seem to be one of the prime targets.

Indeed, these last two examples above make it clear that the Service wants to make sure that the plaintiff receives a Form 1099 for the gross amount of a payment even if two checks are cut. That is a topic that has been the subject of a raging controversy in the courts. There is currently a split in the circuit courts, a problem that cries out for resolution. The IRS certainly has its own views, and if these regulations become final, payors will have to comply.

Watch Out

The new proposed regulations on Forms 1099 issued under Section 6041 have a few provisions that are worth noting. Perhaps most importantly, lawyers are caught up in these proposed regulations whether they want to be or not. Even though there has been a good deal more press coverage on Section 6045(f) and more people are watching for those particular regulations, lawyers should be aware of these rules and the examples set forth in this sleeper set of newly-released proposed regulations.