PAYMENTS TO ATTORNEYS SUBJECT OF REPORTING REGS[1]

By Robert W. Wood

Long known for euphemisms in naming tax legislation, Congress should be especially proud of the host of tough tax laws included within the especially ineptly named "Taxpayer Relief Act of 1997." One provision that has captivated attorneys is a seemingly innocuous reporting rule contained in what is now Section 6045(f).

The subject of attorney fee reporting has been highly controversial, ever since the Taxpayer Relief Act of 1997 added subsection 6045(f) of the Internal Revenue Code. That provision requires companies that make payments to attorneys in connection with legal services to report those payments to the IRS (and also to the receiving lawyer) on a Form 1099. On its face, this may not seem like a big deal. Whether they receive a Form 1099 or not, even lawyers should presumably report all their fee income.

Still, the Section 6045(f) reporting requirement sent a flurry of activity through the attorney community, particularly beginning with January of 1999 when the true wrath of Section 1099 reporting began to be felt. Employment lawyers, whether plaintiffs' counsel or defense, have been particularly hard hit by the attorneys' reporting rules. Employment lawyers have been buffeted by the winds of change wrought by the 1996 legislation, which dramatically cut back on the scope of the exclusion for personal injury damages under Section 104 (physical injuries or physical illness now being required).

Now, these same employment lawyers have to deal with the problem of the netting of attorneys' fees and the alternative minimum tax problems those often cause. Coupled with the new Section 6045(f) reporting requirements, employment lawyers truly have a great deal of tax knowledge to assimilate. And the stakes for both the attorneys and their clients are particularly high.

Like most concepts in our Byzantine tax system, the notion of mere reporting of income is not the real issue, as the reach of Section 6045(f), at least as interpreted by the IRS, is hardly subtle. In fact, the provision requires reporting of many payments that are plainly not income to the lawyer and/or that are duplicative with income (and 1099 reports) attributable to the client. In short, it is a veritable mess, one that many lawyers still don't perceive to be festering. A minority of lawyers have cried foul about this law, lobbying hard to have the provision repealed or, at least substantially modified.

In an employment law context, where the possibility is strong for a hybrid award and reporting may or may not be explicit in the settlement agreement, attorneys may have to not only do a more careful accounting job, but may also have to track more closely the hours they put in on each issue. A client who wants to offset part of a taxable award may do so by deducting attorneys' fees attributable to that claim, although unless a pro rata approach is taken as to the amount of attorneys' fees in relationship to the total award, the employment lawyer should keep careful records of hours spent. In some cases, a larger attorneys' fee deduction may be taken in this circumstance. The employment lawyer may not feel responsible for such tax advice (and indeed, it may be wise for the employment lawyer to be giving a great deal of tax advice). On the other

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hand, some general sensitivity to these tax issues should be present in every employment lawyer's psyche.

Note, too, that the issue has become more complex with the Internal Revenue Service's efforts not to allow so-called "netting" of attorneys' fees (where the gross recovery to the plaintiff is merely reduced by the attorneys' fees, with the plaintiff only reporting [assuming a fully taxable award] the recovery net of attorneys' fees). That is a topic of a separate article, but we should remind readers of BNA's Employment Discrimination Report constantly that this controversy (and there is currently a split in the circuit courts about it) merits careful attention. There is even a bill pending in Congress that would effectively allow netting, but such bills have been introduced before with lack of success. We will see what happens this time.

Proposed Regulations

In the meantime, the Internal Revenue Service has come out with a set of proposed regulations, a set of rules that has the legal community at least metaphorically up in arms. Although they were published on May 20, 1999, they would not take effect until December 31, 1999 (in fact, for payments to attorneys made after December 31, 1999).

These proposed regulations (REG-105312-98) give reporting requirements for payments made to attorneys, and apply not only to attorneys receiving payments on behalf of their clients, but also to attorneys as defendants and their insurance companies who make the payments.

No Minimum

The proposed regulations clarify that reporting is required to attorneys under Section 6045(f) for any amount received, no matter how small. Thus, there is no minimum payment (no counterpart to the threshold $600 rule that is applicable to most types of business payments). Furthermore, the proposed regulations will require payors to file a Form 1099 when a payment is delivered to an attorney, even if the attorney is not listed as a payee.

Even attorneys who eschew any knowledge of tax law should think for a moment what this means. If a check payable to the client is delivered to the attorney, does that mean both the attorney and the client will receive a Form 1099? It certainly seems that way.

The examples set forth in the new proposed regulations are supposed to clarify the scope of these reporting rules. With slight modifications to the examples so that they are somewhat more user-friendly, here are the IRS' examples:

Case 1. Alice, a plaintiff in a suit for lost wages against Dan Defendant, is represented by attorney Larry Lawyer. Alice settles her suit for $300,000. Payment is made by a check payable jointly to Alice and her attorney Larry. Dan Defendant does not know the amount of the attorney fee. Larry retains $100,000 and disburses the remaining $200,000 net proceeds to Alice. Dan must file a Form W-2 for $300,000 with respect to Alice under section 6051. Dan must also file a Form 1099-MISC with respect to Larry for $300,000.

What this suggests, of course, is that there is a potential double counting of income. Even though the IRS is quick to state in its proposed regulations that this $300,000 won't be taxed in full to both Alice and Larry in this example, it is hard to deny the fact that there is only $300,000 paid here, but a total of $600,000 reported as having been paid. Plus, since the IRS is saying that the "wages" paid by Dan to Alice must be reported by Dan on a Form W-2 (instead of a Form 1099), we know that Alice will only be able to claim a miscellaneous itemized deduction for the legal fees paid to

Larry. That $100,000 deduction will, at least in part, be lost to a combination of the 2% threshold, the phaseout of deductions, and the alternative minimum tax.

Case 2. The facts are the same as in Case 1, except that Dan Defendant knows that the attorneys fee is one-third of the settlement amount, or $100,000. Dan must file a Form W-2 for $300,000 with respect to Alice under section 6051. Dan must also file a Form 1099-MISC with respect to Larry Lawyer for $100,000 under section 6041. Dan is not required to file an information return with respect to Larry for $200,000 (the balance of the gross proceeds).

This case demonstrates that in virtually all cases, plaintiffs' counsel should disclose 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 plaintiffs' 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.

Case 3. Perry Plaintiff, a plaintiff in a suit for physical personal injury against Toxic, Inc., is represented by Alan Advocate. Perry settles his suit for damages that are excludable from Perry's gross income under section 104(a)(2). The settlement check is payable jointly to Perry and Alan. Toxic does not know the amount of the attorney fee. Toxic must file a return of information with respect to Alan under paragraph (a)(1) of this section. Toxic is not required to file a return of information with respect to Perry under section 6041 because the settlement amount is excludable from Perry's income under section 104(a)(2).

This case suggests, as in the above examples, that plaintiffs' counsel should always disclose who is getting what. But there is a far more important message hidden in this case. Who determines whether the payment is excludable from Perry's income? The rule has always been—long before the flap over 1099s to attorneys and even before the increase in various other 1099 reporting circumstances of the past ten years—that recoveries are excludable from the plaintiff's income under Section 104 need not be reported. Such payments, after all, are excludable. It is only since 1996, with the amendment to Section 104 that now requires "physical" as opposed to merely "personal" injuries or sickness that the collective antennae of payors truly went up.

Now, 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. This is not much guidance.

Thus, while plaintiffs' counsel may well want to urge a defendant not to issue a 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), plaintiffs' counsel may have to do some convincing (and may have to hire a tax lawyer) for the defendant to agree.

Case 4. Wally Wrongdoer, a defendant in a suit for wrongful injury, knows that Ivan Injured, the plaintiff, has been represented by attorney Saul Solicitor throughout the proceeding. State Bucolic, where the suit is brought, mandates that certain benefits and settlement awards be made payable to the claimant only. Wally makes a check payable solely to Ivan and delivers the payment to Saul's office. Wally has made a payment to an attorney and must file a Form 1099 reporting the full payment to Saul.

This case demonstrates the rule that even the delivery (or mailing) of a check to the lawyer will result in a 1099 being issued to the lawyer. As we noted above, that may seem awfully harsh, especially in a case where the lawyer is not even taking a fee (a pro bono case) and so certifies in writing to the defendant. The maxim we have developed—that plaintiffs' lawyers should disclose in writing exactly who is getting what and make sure it is clear that the 1099s (or W-2s) are issued accordingly—really doesn't work if state law mandates payment solely to the claimant.

Case 5. Derelict, a defendant in a suit for lost wages, reasonably believes that Paul, the plaintiff, has been represented by Claude Counselor throughout the proceeding as evidenced by filings and correspondence signed by Claude. Derelict makes a check for damages payable solely to Paul and delivers it to Claude's office. Derelict has made a payment to an attorney, and must file a return of information under paragraph (a) of this section.

The same comments made above about Case 4 apply here, too, although here the situation can more easily be remedied. The plaintiff's lawyer, Claude in this example, should disclose who is getting what before the settlement documents are prepared and be very clear who will be getting 1099s and W-2s (and in what amounts).

Case 6. Beaten, Inc., a defendant in a suit, makes a payment of the gross proceeds of the amount awarded under the suit to the plaintiff's attorneys, Dewey, Cheatem and Howe. Dewey, Cheatem and Howe are not related parties. The payment is delivered to Howe's office. Howe deposits the monies into her trust account and pays Dewey and Cheatem their respective shares. Beaten must file a return of information with respect to Howe. Howe must file a return of information with respect to Dewey and Cheatem.

This case may not be too interesting unless you see cases with multiple lawyers on the plaintiffs' side. As that is today quite common, this situation will arise with great frequency. My guess is that many plaintiffs' lawyers will not think about these rules, preferring (understandably) to be in control of distributing recovered funds. But at 1099 time (in January of the year following the settlement and payment) the "lead" or disbursing lawyer may well feel that being in control of the funds was not such a good idea after all.

The case illustrations above should make most lawyers sit up and take notice. True, there are exceptions in the proposed regulations, and they may provide relief. The Treasury Department has invited comments on whether additional exceptions to the reporting requirements would be appropriate. I imagine there will be a flood of comments suggesting that additional suggestions are indeed needed.

Which Reporting Form?

The proposed regs do clear up one matter that has been somewhat controversial concerning the type of 1099 form that should be used. The proposed regulations would require that all payments be reported on Forms 1099-MISC, rather than on Forms 1099-B. The regulations would also provide that an attorney's taxpayer identification number does not need to be certified (as by signing an IRS Form W-9). However, payments are subject to back-up withholding if an attorney just flat fails to provide a taxpayer identification number.

Many of the suggestions to the prior proposed regulations were not adopted. For example, the Service rejected (and noted that it rejected), the notion that payors should be relieved of all other reporting obligations under Section 6045(f) by simply shifting the reporting obligations on to the attorney. The IRS apparently felt that this would be an unreliable mechanism of policing what it feels is a significant problem. Another suggestion that the Treasury Department did not adopt was a narrow definition of the term "legal services" that would have excluded any services that did not require the provider to be an attorney. The idea (of certain proponents anyway) was to exempt payments to lawyers for property management services or for financial management services from the notion of legal services, even though such services might be performed by a lawyer. No go, said the IRS in its new proposed regulations.

A public hearing on these proposed regulations is scheduled for September 22, 1999 at 10:00 a.m. at the IRS building in Washington (Room 2615). There is an August 19, 1999 deadline for speaker requests, and outlines of topics to be discussed must be submitted by September 1, 1999. It may be that some of these seemingly duplicative rules will be changed as a result of public comments and the hearing process. Significant ameliorations, though, seem unlikely. Lawyers and their clients should start gearing up for increased sensitivity to the tax reporting aspects of their case. Plaintiffs' lawyers and defense lawyers alike should pay attention, although the consequences of inattention (IRS penalty liability and unhappy and litigious clients) are likely to be greatest for plaintiffs' counsel who do not look carefully at this new minefield.

Caution for Employment Lawyers

As noted above, the proposed regulations concerning the Section 6045(f) attorneys' fee reporting requirements merit close attention by virtually every attorney. However, it is arguable that the largest impact will be felt by employment lawyers. Plaintiffs' lawyers and defense lawyers will need to become at least somewhat accustomed to these rules. It will often be too late to do anything about the manner and method of reporting when IRS Form 1099 filing time comes (the month of January following the year of the payment). It will be an unhappy employment lawyer who must advise a client that the attorney is issuing a 1099 to the client for a recovery that was distributed to the client in the prior year (and which perhaps the client may have entirely spent!).

Likewise, it will be an unhappy employment lawyer who receives a 1099 in January of one year for a large (perhaps multimillion dollar) recovery that the plaintiffs attorney received in the prior year, where the attorney receives a 1099 for the entire recovery (both the plaintiff's portion and the attorney's portion). The gross income of the attorney will presumably be correspondingly increased, perhaps drastically so. Even though the attorney can claim a deduction for the payment out to the client, this kind of simple issue is going to raise concern among employment lawyers. Will audit be more likely? These and other questions have yet to be answered.