

Should Lawyers Fear IRS Forms 1099 for ‘Gross Proceeds’?

By Robert W. Wood

IRS 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 to explain it) is likely to get you an IRS notice in the mail. It might ask questions, or just ask you to pay up for the amount you failed to report. Thus, if you receive a Form 1099, report it in some fashion, even if you are claiming that the money should be tax free.

You’ve heard all this before no doubt, but is it wrong in the case of lawyers? Lawyers, it turns out, are singled out in a couple of ways when it comes to IRS Forms 1099. There are hundreds of pages of regulations about Forms 1099, and there are multiple tax code sections too. Section 6045 of the tax code requires that all gross proceeds paid to an attorney must be reported on a Form 1099, even if the money is not income to the attorney and the attorney is only receiving the money on behalf of their client. There are a few exceptions, but in general, you should assume that money sent to a lawyer or law firm will trigger a Form 1099.

Of course, what *kind* of payment it is matters. If a client is paying a bill, they might issue a Form 1099-MISC with the amount in Box 3, “other income.” That’s the most generic income category of all. Section 6041 of the tax code covers that topic. Or, the client paying a bill might issue a Form 1099-NEC -- that’s the new (in last 2 years) form for payments to independent contractors for services. And when you receive the new NEC form, it generally means self-employment taxes. Finally, the client paying a bill might issue a Form 1099-MISC with the amount in Box 10, “gross proceeds paid to an attorney.”

Lawyers—and their accountants and bookkeepers—should pay attention to what kind of form they receive, and in what box the payment is included. Of course, you need to know if it is a payment of your fees, too. You can’t really know what to put on your tax return without knowing the details. It’s the gross proceeds one I want to focus on here, since it is the one that is most surprising to many lawyers. It is a report of a payment, but not necessarily a report of income, the way the other Forms 1099 and boxes are.

For example, if plaintiff lawyers are settling a case for a client, and most of the funds are really for the client, the gross proceeds Form is still required for the whole amount. The purpose of this reporting is not to examine the attorneys’ income taxes, since most recoveries received by attorneys are not the *attorneys’* income, but their clients’ recoveries. Instead, the general purpose of this lawyer’s reporting is to document the amount of a gross settlement, and to help corroborate a defendant’s tax deduction (if any) claimed on the settlement payment.

It’s to keep track of lawyer payments too. Section 6045 reporting of gross proceeds paid to an attorney is required even if the settlement is tax-free to the plaintiff (say a

physical injury recovery), or is a capital recovery that is generally not reportable to a plaintiff (say a fire recovery for burning down or damaging your house). The plaintiff should not receive a Form 1099, but the lawyer will. And where a recovery is *taxable* to a plaintiff, defendants are generally required to issue a Form 1099 to *both* the plaintiff and the plaintiff’s attorney.

Yes, that is duplicate reporting. In a \$1M settlement to be divided \$600k to client, \$400k to lawyer, the lawyer will usually get a Form 1099 for \$1M, and so will the client for the full \$1M (again, assuming that an exception does not apply for the client). Gross proceeds paid to an attorney are not reported as income on the Form 1099, but are instead reported in a special box, Box 10, which is specifically labeled as “gross proceeds paid to an attorney.” Unlike the other boxes on a Form 1099, the IRS does not assume that amounts reported in Box 10 are income.

In fact, in my experience, Box 10 reporting rarely results in a tax examination for an attorney who receives Box 10 reporting. Note that the gross proceeds reporting for lawyers applies even if the law firm is a corporation, overriding the normal Form 1099 rule that you don’t have to issue Forms 1099 to a corporation. Of course, whether you receive a Form 1099 for a payment or not, you must report your income, all of it. And if you receive Form 1099-NEC, or a 1099-MISC Box 3 (other income), you should declare it as income. But how about all those big gross proceeds Forms 1099, box 10?

That one is different. If a \$1M settlement is reported and \$400k is your fee, what should you do? Plainly, you must report your \$400k fee. However, you do not need to report the \$1M and deduct the client \$600k. You just report your fee. You don’t need to report the \$1M Form 1099 as gross income, since it is not reporting that amount as *income* to you.

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. If the defendant is savvy about taxes, they are likely to know that how the checks are cut may not obviate duplicate reporting of the legal fees.

In 2005, the U.S. Supreme Court decided the *Banks* case, ruling that plaintiff’s generally have gross income on 100% of a case, even if they only net 60% and never see the direct payment of the 40% to their lawyer. Put another way, the Supreme Court said that as a general rule, the money is *all* really the client’s for tax purposes. The client then pays the lawyer (even if the lawyer nets the payment before the client touches it).

That is why clients care deeply about whether they can deduct legal fees. In many cases they can, though there are exceptions. And even if the plaintiff is entitled to deduct legal fees, there are nuances that often make it necessary for

plaintiffs to need professional tax help. As for lawyers, paying attention to Forms 1099 is important. And lawyers issue a great many Forms 1099 too—that's a topic we'll tackle on another day.

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