

# Tricks and Traps For Lawyers With IRS Form 1099

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Lawyers and clients should care about IRS Forms 1099. They are used by payers and payees to report payments outside the employment relationship,<sup>2</sup> and allow computer matching of Social Security numbers and dollar amounts paid and received, so that IRS collection efforts can be streamlined and automated. In most cases, Forms 1099 report payments that qualify as income of one type or another and affect the amount (and, in some cases, the type) of taxes you pay. There is an exception to that general rule, however, that is important to both lawyers and their clients: a Form 1099 can report gross proceeds to lawyers, which may reflect payments that do not constitute income to either the attorney or their client<sup>3</sup>—but it is a category that a surprising number of lawyers may not understand.

If you receive a Form 1099 in the mail, open it and check the numbers. Errors in reporting do occur, of course, so if you believe a Form 1099 is wrong, you may be able to get the issuer to correct or undo it. But that is usually tough unless it is demonstrably an error. If you cannot get it corrected, you will likely be required to report the entire amount on your tax return, and will have to explain the error there.

For example, suppose you receive a Form 1099 on which a company reports that it made a payment to you of \$100,000, but you can prove that the company actually paid you only \$10,000. You hope the company would correct *that* kind of error. If you cannot get the company to correct it, however, you have no option other than to report the \$100,000 on your tax return for the year and explain that you actually received only \$10,000.

Unfortunately, in the author's experience, most "please fix my Form 1099" requests fall on deaf ears. That may be because the issuer of the form believes it

issued the form correctly. And, it must be admitted, many Form 1099 reporting issues that seem like errors really are not. Suppose you are a plaintiff who receives a \$100,000 legal settlement, from which your lawyer collects a 40% contingent fee of \$40,000, leaving you with a net amount of \$60,000. Even if the defendant paid your lawyer their \$40,000 directly and you never received more than your \$60,000 share, you—the client—will usually receive a Form 1099 for the full \$100,000.

This result is the consequence of the Supreme Court's decision in the 2005 case *Commissioner v. Banks*.<sup>4</sup> Under *Banks*, plaintiffs are treated for tax purposes as receiving the entire gross legal recovery, including the portion paid to or retained by their attorneys for their contingent fees. Thus, under *Banks*, the hypothetical plaintiff in the preceding paragraph is treated as receiving the entire \$100,000 gross recovery for tax purposes, and then as paying their attorneys the \$40,000 contingent fee. Defendants' Form 1099 reporting obligations follow the *Banks* decision, and generally require the defendant to report the entire gross recovery, including the portion retained by their attorneys as contingent fees, as paid to the plaintiff.<sup>5</sup>

Failing to report a Form 1099 on your tax return (or at least explain it) is not an option: The payment will have been reported to the IRS by the payor, and the IRS, when it fails to see the form reported on your tax return, may send you a notice inquiring about the discrepancy. Thus, if you receive a Form 1099, report it, even if you claim that the money should be tax-free; report it even if some of it really went to your lawyer and you are entitled to a tax deduction for legal fees.

Ideally, both a plaintiff and their lawyer should think about how any payments will be reported concurrently

with the negotiation of any settlement. Arguing after the fact that the defendant should have issued two Forms 1099—one to plaintiff and one to lawyer—is nearly always a waste of time: the only time you have any bargaining power to control how Forms 1099 will be issued in respect of a settlement is *before* the settlement agreement is signed. In some cases, a defendant might be persuaded to completely avoid a Form 1099, as would be appropriate with respect to that portion of a settlement fairly attributable to physical injuries, physical sickness, and related emotional distress.<sup>6</sup>

### Forms and Boxes on Forms

Generalized knowledge of, and worry about, Forms 1099 may cause some clients, as well as some lawyers, to prefer separate checks: one for the funds paid 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 they can sidestep tax on the legal fees that way. But things are not that simple. Attorneys and their clients should consider the realities, and the different boxes on a Form 1099, before deciding how they would like settlement payments to be recorded.

There are different Forms 1099—and different *boxes* on a Form 1099—that signal different things to the IRS, and it is not the case that one Form 1099, or one box on a Form 1099, is as good as another. You should understand what the different form and boxes mean, and may want to make it explicit that the defendant should record one or more components of a settlement payment on one form, or in one box, instead of another.

What difference do forms and boxes make? The most common version used is Form 1099-MISC, for miscellaneous income, and, until 2020, all payments to an independent contractor were required to be reported on the Form 1099-MISC, in box 7, for “non-employee compensation.”<sup>7</sup> Since January 1, 2020, however, payments for services have been required to be reported on the newly created Form 1099-NEC.<sup>8</sup> The NEC stands for “non-employee compensation,” and, unsurprisingly, the Form 1099-NEC is now used to report non-employee compensation, including, chiefly, payments to independent contractors.

### Self-Employment Tax

For 2019 and prior years, reflecting payment to someone in box 7 of a Form 1099-MISC usually tipped the IRS off that the payee should not only be paying income tax, but also paying self-employment tax on the payment.<sup>9</sup> Self-employment tax is equivalent in amount to the sum of both the employer and employee payroll taxes that apply to wages, which are reported on Form W-2. Self-employment tax can add a whopping 15.3% tax with respect to a payment, on top of income taxes.<sup>10</sup> That 15.3% applies to all payments up to \$137,700 (i.e., the wage base to which employment taxes apply), with a 2.9% tax thereafter on any excess over the wage base—and there is no limit on that 2.9%, even if you earn millions.<sup>11</sup> In short, self-employment tax is nothing to sneeze at, and all payments made on a Form 1099-NEC will be subject to that tax.

The author expects that, in early 2021, there will be considerable confusion about Form 1099-NEC, and there might even be some disputes. Through 2019, if you were paying someone on a Form 1099, the main choice you made as to how to report a payment was between box 3 (for “other income”) and box 7 (as noted above, for “non-employee income”). Box 3 reflects a more neutral category than did box 7, because of the self-employment tax, so that most payees would rather receive amounts reported in box 3 than in box 7. Sometimes, as may be the case with payments under a settlement agreement, you can specify how you want amounts recorded. Prior to 2020, if you failed (or were unable) to do that, however, the payer of the money generally picked whatever reporting they thought was best and issued the Form 1099-MISC as they deemed appropriate. For 2020 and going forward, failing to address the tax reporting with the payor not only leaves the payor with the discretion of what box to use on the Form 1099-MISC, but also to decide whether the payment should instead be reported on the Form 1099-NEC, which even more unambiguously denotes that the income is subject to self-employment taxes.

### Other Income or “Gross Proceed Paid to an Attorney”?

What about Form 1099-MISC, now that box 7 has essentially been transformed into a whole new tax form? For 2020 and subsequent-year payments, your choices on Form 1099-MISC are more limited. Most payments

are recorded in box 3, as “other income.” For lawyers settling cases, though, box 10, “gross proceeds paid to an attorney,” is the most important category. Many lawyers may not see Forms 1099 that arrive at their office (because they are handled by other staff), but lawyers should be aware of this important box on the form, and what it means for their taxes.

For payments made through 2019, IRS Form 1099-MISC box 14 was used to report gross proceeds paid to an attorney, and payments made in 2019 but reported in early 2020 would have been reported on the 2019 forms. Payments made in 2020, however, will be reported in January 2021, in box 10 on a new version of Form 1099-MISC.

Whether box 14 on earlier Forms 1099-MISC or box 10 on the new ones, that box is only for reporting payments to lawyers—and, it turns out, there are numerous special Form 1099 rules for lawyers, and how payments to attorneys are reported impacts their clients, too.

Why is the amount of gross proceeds paid to an attorney category so important? For one thing, an amount paid to a lawyer as “gross proceeds” is not counted as income to the lawyer. Any payment to a lawyer is supposed to be reported by the paying party, even if it is all the lawyer’s client’s money, paid to close a real estate deal. Case settlement proceeds count as gross proceeds, too.

Say that a lawyer settles a case for \$1 million, with payment of the entire amount made to the lawyer’s trust account. Assume that 60% is for the client, and 40% is for the lawyer as a fee. The lawyer is sure to receive a Form 1099 reporting the full \$1 million as gross proceeds, but the lawyer need not report the full \$1 million as income, because it is not. In fact, the lawyer can simply report as income the \$400,000 fee, without worrying about computer matching against the payor’s Form 1099 reported to the IRS, since gross proceeds do not count as income. The client is not so lucky. Unless the settlement is a non-income settlement (compensatory damage for personal physical injuries)<sup>12</sup> or a capital recovery,<sup>13</sup> the client in this example will receive a Form 1099-MISC (probably reported in box 3) for the full \$1 million.

The client must then figure out how to deduct the \$400,000 in legal fees that went to their lawyer. Not all

legal fees are deductible,<sup>14</sup> and it is harder to find a way to claim them in many kinds of cases since 2018.<sup>15</sup>

In any event, even though gross proceeds reporting on Forms 1099 is a very good deal for lawyers, in other ways lawyers are disadvantaged when it comes to Forms 1099. Lawyers receive and send more Forms 1099 than most people, in part because of tax laws that single them out for auditing.

### Lawyers, IRS Audits, and Forms 1099

Lawyers make good audit targets because they often handle client funds, and many also tend to have high incomes. And, since 1997, most payments to lawyers must be reported on a Form 1099—making it easier for the IRS to track whether a lawyer is reporting all their receipts.

In addition, the reporting burden on lawyers as payors may be substantial. The basic Form 1099 reporting rule (for lawyers and everyone else) is that each person engaged in business and making a payment of \$600 or more for services must report it on a Form 1099.<sup>16</sup> The rule is cumulative, so while one payment of \$500 would not trigger the rule, two payments of \$500 to a single payee during the year require a Form 1099 for the full \$1,000. Lawyers must issue Forms 1099 to expert witnesses, jury consultants, investigators, and even co-counsel, when services are performed and the payment is \$600 or more.

A notable exception to the \$600 threshold reporting rule from which lawyers benefit as payors is one for payments to corporations for services.<sup>17</sup> However, the rule that payments to a lawyer must be the subject of a Form 1099 trumps the rule that payments to a corporation need not be. Thus, any payment for services of \$600 or more to a lawyer or law firm must be reported on Form 1099. It does not matter whether the law firm is a corporation, limited liability company, limited liability partnership, or general partnership. Nor does the size of the law firm matter; it might have one lawyer or thousands.

That rule affects law firms as issuers of Forms 1099, as well—and their clients. A lawyer or law firm paying fees to co-counsel or a referral fee to a lawyer must issue a Form 1099 regardless of how the lawyer or law firm is organized. Moreover, any client paying a law firm more than \$600 in a year as part of the client’s business must issue a Form 1099.

## Exceptions to the Gross Proceeds Designation

Although many payments to lawyers can—and should—be reported as gross proceeds paid to an attorney (box 10, starting with the 2020 form), not all payments to an attorney should be reported that way. For example, a payment of legal fees to the lawyer should probably be reported in box 3.<sup>18</sup> However, many parties seem to opt for gross proceeds reporting even then.

Some businesses and law firms prefer to issue Forms 1099 at the time they issue checks to a payee, rather than in January of the following year. For example, a law firm mailing out thousands of checks to class action recipients might prefer sending a single envelope that includes both the recipient's check and a Form 1099 to sending a check first and later having to undertake another mailing with a Form 1099.

## Joint Payees and Forms 1099

Lawyers are often joint payees, and IRS regulations contain extensive provisions governing joint checks. Most of these rules mean that when legal settlements are payable jointly to lawyer and client, lawyers will be receiving Forms 1099 along with their clients. In general, two Forms 1099, each listing the full amount, are required.

In addition, many lawyers receive funds that they must pass along to their clients. That means law firms often cut checks to clients for a share of settlement proceeds. When a plaintiff law firm disburses money to clients for legal settlements, should the law firm issue a Form 1099 to its own client? Some firms issue the forms routinely, but most payments to clients do not actually require it.<sup>19</sup> The reason is that most lawyers receiving joint settlement checks to resolve client lawsuits are not considered payers. In most cases, the settling defendant is considered the payer. Thus, the defendant generally has the obligation to issue any Form 1099 that is required.

If lawyers perform management functions and oversight of client monies on behalf of clients, they become payers required to issue Forms 1099, but just being a plaintiff's lawyer and handling settlement money is not enough to impose that obligation upon them.

## Conclusions

Every tax return must be signed under penalties of perjury. That makes tax returns themselves the most important tax form of all. They are not to be taken lightly.

Still, as vast a number of important tax forms as there are, it is hard to think of many, other than our tax returns, that are more important or pivotal to our tax system than the little Form 1099 that most of us see many of every year. Whether you are paying money or receiving money, consider that form, not just at tax time, but throughout the year. There are hundreds of pages of IRS regulations regarding Forms 1099,<sup>20</sup> and this article only scratches the surface. Remember, too, that not everyone is likely to agree on how and when the forms should be issued. Differences of opinion are common, even among seasoned tax professionals, so plan ahead.

## Endnotes

- 1 Robert W. Wood is a tax lawyer and managing partner at Wood LLP. He can be reached at Wood@WoodLLP.com.
- 2 Treas. Reg. § 1.6041-1(a)(2).
- 3 See I.R.C. § 6045(f).
- 4 *Comm'r v. Banks*, 543 U.S. 426 (2005).
- 5 See Treas. Reg. § 1.6045-5(f), ex. 3.
- 6 See *id.* §§ 1.6041-1(f)(1), 1.6045-5(f), ex. 2.
- 7 See, e.g., I.R.S. 2019 INSTRUCTION FOR FORM 1099-MISC, AT 7.
- 8 See, e.g., I.R.S. 2020 INSTRUCTIONS FOR FORM 1099-MISC AND 1099-NEC, AT 1.
- 9 See I.R.C. §§ 1401, 1402.
- 10 I.R.C. § 1401(a),(b)(1).
- 11 *Id.* §§ 1401(a), (b)(1), 1402(b)(1).
- 12 See Treas. Reg. § 1.6045-5(f), ex. 2.
- 13 See I.R.S. 2020 INSTRUCTIONS FOR FORM 1099-MISC AND 1099-NEC, AT 5–6; I.R.S. PRIV. LTR. RUL. 94-51-052 (DEC. 23, 1994); REV. RUL. 80-22, 1980-1 C.B. 286.
- 14 See, e.g., I.R.C. §§ 263, 265.
- 15 See Wood, *Workarounds for Plaintiffs & Lawyers Under New Tax Law*, 2020 BUS. L. NEWS, 1, 38.
- 16 I.R.C. § 6041(a).
- 17 Treas. Reg. § 1.6041-3(p)(1).
- 18 I.R.C. § 6045(f)(2)(B) (“This subsection shall not apply to the portion of any payment which is required to be reported under section 6041(a) (or would be so required but for the dollar limitation contained therein) or section 6051.”).
- 19 See Treas. Reg. § 1.6041-1(e).
- 20 See, e.g., Treas. Reg. §§ 1.6041-1-1.6041-10, 1.6045-1-1.6045-5.