



When Clients Must Report Fee Payments

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Rarely is the IRS compared to Greeks bearing gifts. Still, missives from the IRS that seem innocuous--even kindly--can hide sinister weapons. That is just the situation with recently issued final regulations on reporting payments made on behalf of others, or Middleman regulations. (T.D. 9010, 2002 TNT 144-10 (2002).)

Rules governing reporting payments to attorneys have been extraordinarily controversial. Among the more debated provisions is section 6045(f). Enacted in 1997, it requires most payments to attorneys to be reported on the dreaded Form 1099. Unfortunately, the concept--theoretically so simple--has turned into a mess. The issue can have a huge impact on a taxpayer's ability to structure a settlement that won't be whipsawed by the alternative minimum tax. It is no secret that the circuit courts of appeal do not agree on the proper tax treatment of recovered contingent fees--and the controlling regulations frequently make planning in this area difficult.

Wheel In the Trojan Horse

The IRS recently rolled out final regulations, effective January 1, 2003, ostensibly aimed at escrow agents and others who make payments on behalf of another person. But lurking in the belly of these regulations are reporting rules for payments by and to attorneys and clients--rules that have little to do with escrow agents and lots more to do with an acidic split in the federal circuits and the underlying revolt over the attorney payment regulations.

There is a well-publicized rift between the federal circuits over whether the portion of a damages award or settlement payment used to pay a plaintiff's attorney fee must be included in the plaintiff's gross income or whether only the net amount received must be reported. (*Compare Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir. 2001), cert. denied, *Sinyard v. Rossotti* (536 U.S. 904 (2002) (including fees); *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000) (excluding fees).) When attorneys fee payments are included in a plaintiff's gross income, the plaintiff is generally entitled to a deduction, but it is typically a miscellaneous itemized expense. The uninitiated may not see much difference between an exclusion and a deduction. But the benefit of this deduction is often reduced and can be virtually eliminated because of the alternative minimum tax. (See, § 56(b)(1)(A).) And sections 67 and 68 impose further haircuts on the deduction. Section 67 generally allows a deduction only to the extent it exceeds 2 percent of the taxpayer's adjusted gross income. Section 68 also reduces certain itemized deductions by 3 percent based on the extent a taxpayer's gross income exceeds the "threshold amount," which for 2004 is \$142,700.

Up to now the reporting rules have not been explicit in requiring a payor to issue a Form 1099 to the client for the attorney payment, even in those states and circuits holding that an attorney payment is gross income to the client. That may seem like splitting hairs--something lawyers often do best--but at least a plaintiff who does not receive a Form 1099 showing the fees has more of a fighting chance of showing no increased income.

It is not surprising that this legal nicety would one day end, particularly given the controversy surrounding the hotly divided circuit courts--all of which have weighed in on this issue. But it seemed likely that the IRS would put the controversy to rest only through final regulations. After all, even the IRS referred to the attorney payment regulations as those "relating to the reporting of payments of gross proceeds to attorneys." (Preamble, T.D. 9101 (2002).) The description also states the regulations "clarify the amount to be reported," which in hindsight should have been a red flag.

Much like a game of football in which several players suddenly start playing rugby, the IRS has done a kind of end run and put the new 1099-for-attorneys-fees surprise in a plain brown wrapper--or, if you prefer, a wooden horse: the Middleman regulations. That will catch a lot of people off guard--particularly plaintiffs lawyers who have been fighting about the likely effects of the attorney payment regulations.

Gross Income Reportable

The Middleman regulations include a rule for the amount a payor must report when a payee takes deductions from the payment. (Reg. § 1.6041-1(f).) Beginning in 2003, a payor must report the amount includable in the gross income of the payee before fees, commissions, expenses, or other amounts have been deducted. This rule applies "whether the payment is made jointly or separately to the payee and another person." (Reg. § 1.6041-1(f).)

The examples in the Middleman regulations make clear that this rule controls whether a defendant must report payments made to the plaintiff's lawyer that represent the lawyer's own fees. They generally require a defendant to issue a plaintiff a Form 1099 that includes the attorneys fee payment whenever it is includable in the plaintiff's gross income.

To comply with section 6041, a defendant must analyze the substantive law on attorneys fees inclusion as it applies to a plaintiff before reporting a payment. That is even more tricky than it may seem. The IRS has assumed a restrictive stance: It contends that even in federal circuits that permit a plaintiff to exclude attorneys fees, that rule applies only to taxpayers who reside in Alabama, Michigan, and Texas.

Section 6041 and Middlemen

Section 6041(a) contains the general reporting rule for payments of \$600 or more made in the course of a trade or business. It requires reporting payments of salaries, wages, compensation, fees, and other forms of fixed or determinable income. Some limitations are built into the general rule. For example, section 6041 does not apply to reporting payments outside of a trade or business. Thus, it does not apply to legal fees paid for a divorce since those are personal expenses. (Rev. Rul. 85-101, 1985-2 C.B. 301.) It also does not apply to payments that are not gross income to the payee. (See, LTR 8722088, 1987 WL 420654 (1987).) For example, settlement payments for physical injury or physical sickness excludable under section 104(a)(2) need not be reported. (See, IRS 2003 Instructions for Form 1099-MISC, at p. 4 (instructing taxpayers not to report payments of damages received for physical injury or sickness).)

The Middleman regulations are a subset of section 6041's general reporting rule. They apply to people making payments on behalf of others--in other words, middlemen. The rules try to answer the question of who is the "payor" for purposes of section 6041, and they therefore indicate who must report the payment. According to the regulations, a person is a section 6041 "payor" if he or she either:

1. performs management or oversight functions in connection with the payment, or
2. has a significant economic interest in the payment.

Ambiguity in Management and Oversight

For attorney-related payments, it is the management and oversight prong that is most likely to trigger reporting duties. Unfortunately, the regulations do not define this term except in the negative. In particular, they state management and oversight does not include "mere administrative or ministerial functions such as writing checks at another's direction." (Reg. § 1.6041-1(e)(1)(i).) Management and oversight, according to the preamble, is a question of fact.

In reality, it seems to matter how much control a middleman exercises over both making the payments and the services for which they are made. But beyond that, there is much gray area. Perhaps the most we can take away from these rules is that anyone making payments on behalf of another who has discretion over the payment amount, timing, or services provided should look very carefully at the Middleman regulations. The message to report whenever in doubt—a frequent IRS warning—may be one of the agency's most insidious ones.

Reporting Duties

Enacted as part of the Taxpayer Relief Act of 1997, section 6045(f) explicitly imposes reporting obligations on certain attorney-related payments in addition to those in section 6041 and the Middleman regulations. It generally requires information reporting for any payment made to attorneys regarding legal services, even when the services were not provided to the payor. For example, a third party, such as a defendant's insurer that issues a settlement check to the claimant's attorney, may be required to report the payment.

Piecing Together the Puzzle

With this navigational guidance in mind, it is worth exploring an example involving payments to an attorney and client to see how the Middleman regulations interpret sections 6041 and 6045(f).

Example: Paula Plaintiff recovered lost profits in a claim for breach of contract from Egregious Employer, her former employer. Egregious paid the fees into a trust account maintained by Lawrence Lawyer, Paula's attorney. Lawrence used the funds to pay experts, costs, and other litigation expenses. With respect to those payments, Lawrence decided whom to hire, negotiated the amount of payment, and determined whether the services were performed satisfactorily. Lawrence also had the right to withhold payment in case of a dispute. After paying his own fees, Lawrence paid the net amount to Paula.

According to the Middleman regulations, here is how sections 6041 and 6045(f) apply to the reporting obligations of Lawrence, Paula, and Egregious.

Lawrence's payments to the third parties. The Middleman regulations apply to Lawrence's payments for experts, costs, and litigation expenses. Lawrence made those payments on behalf of Paula; his reporting duties therefore depend on whether he performed management and oversight functions or had a significant economic interest in the payments. The Middleman regulations tell us that under these facts, Lawrence performed management and oversight functions. They do not tell us, however, which act was determinative. Lawrence must file information reports for those payments. However, if a client were responsible for, say, hiring an expert, negotiating payments, or approving the work, the attorney paying the expert may very well not be required to report the payment under section 6041.

Lawrence's payment to Paula. Lawrence paid Paula the net proceeds that Egregious owed her as a result of the lawsuit—in other words, he paid on behalf of another. The Middleman regulations conclude, without analysis, that Lawrence neither performed management and oversight functions as to this payment nor had a significant economic interest in it. Lawrence therefore has no information-reporting duties for this payment under section 6041. Since the tests in the regulations are questions of fact, it is at least theoretically possible that section 6041 requires reporting when an attorney pays a net recovery amount to a client. However, it is difficult to imagine such a case.

Egregious's payment to Lawrence. The Middleman regulations instruct Egregious to consult section 6045(f) for reporting duties, suggesting that section 6041 does not require Egregious to report the payment. That result is consistent with the preamble to the Middleman regulations when they were proposed. (Preamble, T.D. 9101 (2002).) The preamble explained that a defendant does not perform management or oversight in connection with payments to a claimant's attorney—and is not a section 6041 payor. A defendant is therefore not required to report the payment under section 6041; that duty falls to the plaintiff.

But Egregious must still contend with section 6045(f). That complicates matters. If section 6045(f) were to employ the same definition of *payor* as in section 6041, then it appears Egregious would not be a payor under either section and could legitimately argue that neither section required it to report the payment.

But the preamble to the attorney payment regulations attempts to cut the legs off this argument. It states that *payor* is defined differently for purposes of section 6045(f) than for section 6041. According to the preamble, the IRS and Treasury believe Congress intended for section 6045(f) to apply to payments by insurers and defendants to a plaintiff's attorney. The attorney payment regulations try to force Egregious to report the payment by defining payor to include "an obligor on the payment, or the obligor's insurer or guarantor." (Prop. Reg. § 6045-5(d)(3).) Egregious, then, is not a payor under the Middleman regulations, although it is under the proposed attorney payment regulations.

Keep in mind, though, that the regulations will only become effective if they are finalized. Until then, the definition of *payor* under section 6045(f) is somewhat up for grabs. Egregious, for example, could conceivably argue that the definition of payor in section 6041 applies to section 6045(f). In that case Egregious would not be required to report under either statute.

Egregious's payment to Paula. The Middleman regulations refer Egregious to the section 6041 regulations setting forth the general reporting rule (Reg. § 1.6041-1(i) and (f)), which indicates the payment is outside the scope of the Middleman regulations. Thus Egregious must report the payment to Paula if it otherwise qualifies under section 6041—for example, it is \$600 or more, made in the course of Egregious's trade or business, and constitutes gross income to Paula.

Assuming Egregious is required to report the payment, it may be required to report its entire amount. Paula is required to include it in her gross income, including Lawrence's legal fees. (See § 1.6041-1(f).) Determining the correct amount to report to Paula requires Egregious to determine:

1. which circuit's law applies to Paula
2. whether, under the law in that circuit, Lawrence's fees are includable in Paula's gross income, and
3. whether the IRS is right in restricting that rule to certain states within the circuits.

The Middleman regulations are silent regarding which rules apply to payments made by a defendant's insurer. One might suspect they should be governed by the same rules that apply to Egregious. Yet there is a factual difference: Egregious's payments arose from services Paula performed for it. A payment by the insurer would be for services Paula rendered to someone else—Egregious. Thus the insurer would arguably be making payment on behalf of Egregious. As such, it may be

operating under the Middleman regulations. In that event, the insurer's reporting obligations under section 6041 would turn on whether it performed management and oversight functions or had an economic interest in the payment.

Paula's payment to Lawrence. The regulations instruct Paula to see the general 6041 reporting rule (§ 1.6041-1(a)(i)) as well as the particular rule for payments for professional services. It appears that Paula may be required to report the portion of Egregious's payment that constitutes Lawrence's fees to Lawrence, although her reporting duties would be subject to the limitations on the general reporting rule. For example, Paula's attorneys fees would not need to be reported if they were occasioned by personal reasons such as a divorce.

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