WHY TAX TREATMENT OF ATTORNEYS' FEES SHOULD BE ADDRESSED IN SETTLEMENT AGREEMENTS[1]

By Robert W. Wood

Virtually every litigation settlement document should include discussion of the tax consequences the parties intend for the settlement. It helps avoid disputes between the parties, and disputes with the Internal Revenue Service and state taxing authorities. There have been too many cases in which one party anticipates there will be no withholding or no IRS Form 1099, and the other party assumes to the contrary. This is only one example of the many disputes that can arise. These disputes are painful in time, expense and even potential and malpractice exposure.

Another reason for addressing the anticipated tax consequences of a settlement is that it can definitely influence the Internal Revenue Service's willingness to agree with the parties that the treatment you specified is appropriate. Neither the IRS nor the courts are bound by tax language in the settlement agreement, but it certainly has an effect. Indeed, the settlement may actually disintegrate if a disagreement about tax matters is big enough. A few cases have explicitly considered what happens when a settlement agreement is breached purely by reason of a tax dispute.

A Breach is a Breach

In Bowden v. U.S., the Court of Appeals for the D.C. Circuit faced just such an issue. This case involved a former immigration and naturalization service employee who had charged the Immigration and Naturalization Service by which he was employed with race discrimination in 1978. He settled his claim in 1990 in exchange for a lump-sum backpay award.

Under the settlement agreement, the INS paid Mr. Bowden $190,000, which represented $242,000 (the agreed amount of the settlement) minus payroll tax deductions. The IRS and the Maryland Tax Department then notified Bowden in April of 1991 that he owed additional taxes on this settlement. He wrote to the INS several times beginning in December of 1991, asserting that the INS had agreed to pay all taxes on the settlement. The INS, predictably, responded that it had already paid appropriate payroll taxes and that any further tax problems were Bowden's alone.

Bowden then filed suit in the Federal District Court in the District of Columbia arguing that his settlement agreement with the INS had been breached. The District Court dismissed this suit without prejudice, finding that the suit would have to be brought within the Federal Court of Claims. The Court also found that he had failed to exhaust administrative remedies regarding negligence under the Federal Tort Claims Act. Then Mr. Bowden went to Claims Court. There, the INS argued that the first two counts Bowden asserted were outside the jurisdiction of the Claims Court. (It surely did not endear the INS to the Claims Court that this was contradictory to the position the INS had taken in the Federal District Court!)

The Claims Court sent the case back to Federal District Court. Once again, the Federal District Court dismissed Bowden's suit, this time with prejudice. The District Court found that Bowden failed to make a timely claim of breach of the settlement agreement, that he was not entitled to interest under the Back Pay Act, and that he failed to exhaust administrative remedies on his tort claim.

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Then the matter went to the D.C. Circuit. There, the Court found that Bowden failed to file an administrative complaint within thirty days of receiving the tax bills, as is required by 29 C.F.R. 1613.217(b). The Court further found that the INS had no responsibility to notify him of this time limit. However, the Court found that the INS did waive a defense by responding to the merits of Bowden's complaint without requesting his timeliness. The INS also failed to raise the defense in the first suit before the District Court, or before the Claims Court in its contradictory jurisdictional arguments.

According to the Court, the crux of Bowden's position was that he and an INS official had reached an oral agreement that the INS would pay all taxes, and this oral agreement was inadvertently omitted from the written settlement document. The government argued that evidence of prior oral agreements is barred by the Parol Evidence Rule, and that the written agreement included an integration clause that voided all prior agreements.

Despite what might seem the appeal of that legal argument, the D.C. Circuit remanded the case to the District Court for a determination of whether the agreement was partially or fully integrated. According to the appellate court decision, if the lower court finds that the agreement is fully integrated, it may not consider extrinsic evidence about an alleged oral agreement to pay taxes.

Eighth Circuit, Too

Bowden was not the only case to present such a mess. In 1995, the Eighth Circuit decided in Sheng v. Starkey Laboratories, Inc. There, the failure of the parties to agree on the tax treatment of a settlement in a sex discrimination case was considered a material issue that prevented the finding of an enforceable contract between the parties. The federal District Court ordered enforcement of a settlement between the parties after one of the parties balked at the deal. The Eighth Circuit reversed.

This story has its beginning in a simple employment dispute. The underlying claim was made by Beihua Sheng, a former employee of Starkey Laboratories who sued for sexual harassment and retaliation. Although a settlement was reached at the $73,500 figure, there was confusion about just what happened in the settlement conference. The respective parties met for a settlement conference in front of a Magistrate in the U.S. District Court for the District of Minnesota. The parties were referred to the settlement conference by a judge who had presided over the litigation of Sheng's discrimination claims.

After some discussion, the attorneys for Sheng and Starkey Laboratories shook hands on the $73,500 figure. Unfortunately, the attorneys could not agree on the tax treatment of the settlement. Not surprisingly, Sheng's attorney asked for an assurance that Starkey Laboratories would not withhold taxes from the proceeds. Starkey Laboratories, on the other hand, asked for an indemnification clause that would protect the company in the event the Internal Revenue Service thought that withholding was required. According to Sheng's lawyer, the parties had agreed to meet again to iron out this nettlesome tax question.

When is a Settlement a Settlement?

Later that day, the parties learned that the judge presiding over the substantive discrimination suit had granted summary judgment to Starkey Laboratories on December 17, 1993 (three days before the settlement conference before the magistrate had even begun!). When this judge became aware of the settlement on December 20, he withdrew his December 17 order which had granted summary judgment. On December 21, he issued a new order endorsing the settlement and dismissing the plaintiff's case without prejudice.

The plaintiff tried to enforce the alleged settlement for $73,500. Starkey Laboratories, on the other hand, sought to reinstate the December 17 summary judgment ruling so that it could escape payment altogether. Starkey Laboratories argued that there could not have been an enforceable settlement either because: (1) the parties were negotiating without the knowledge that summary judgment had already been granted; or (2) they had failed to reach a complete agreement on material terms—because the tax treatment of the settlement proceeds had not been addressed.

The District Court determined that the summary judgment ruling had not "matured" into a court order before the settlement was reached. The court also determined that the failure to agree on tax consequences did not preclude a finding that the settlement had been reached. Indeed, the court noted that on December 20, 1993, the IRS had issued a Revenue Ruling (No. 93-88) ostensibly settling the question that settlement proceeds in a post-1991 Title VII claim are not taxable. Regardless of what the parties thought, then, the court acknowledged that the IRS would not attempt to tax the proceeds.

Taxes Are Material

Starkey Laboratories did not give up here. On appeal to the Eighth Circuit Court of Appeals, the defendant argued that no settlement was ever reached because they had not agreed on the tax consequences of the settlement payment when they became aware of the summary judgment ruling. A "mutual mistake of fact" on the part of the parties existed, argued Starkey. The Eighth Circuit Court of Appeals listened intently to these arguments, and reversed the district court because the settlement was inchoate.

Applying basic contract law, the Eighth Circuit Court of Appeals concluded that no contract exists unless the parties agree to all material terms. What is a "material" term has to be evaluated when the contract is being formed. Events occurring subsequent to the settlement agreement (here, the later IRS Revenue Ruling about Title VII recoveries) could not make terms that were material at the time a deal was being considered into nonmaterial terms. The tax and indemnity issues, reasoned the court, were material terms on which no agreement had been reached between the parties. That vitiated the settlement.

The final chapter in Sheng v. Starkey Laboratories, though, came on remand of the case to District Court. There, the District Court found the parties had reached agreement on all essential terms of settlement. Consequently, the court rescinded the dismissal order and reinstated the summary judgment order in Starkey's favor. Sheng appealed!

In the Circuit Court for the second time, the Eighth Circuit agreed with the District Court (on remand) that the settlement did not hinge on the tax issues. Plus, the Eighth Circuit found that summary judgment motion and the judge acting on it did not give rise to a mistake of fact that vitiated the settlement.

Imagine all the legal fees generated by these two District Court decisions and two appeals? All of this was after the execution of a settlement agreement, making a rather dramatic case for considering these issues before a settlement agreement is finally negotiated.

Address Taxes to Save Taxes

If the cases described above do not present sufficient reason for virtually everyone to try to address anticipated tax consequences in the settlement document purely because of the risk that the settlement may fall apart entirely for failing to do so, then a more substantive tax consideration may be the deciding factor. It is well established that most of the litigated cases to consider what tax treatment ought to apply to a certain type of payment involve general releases with no allocated settlement. In my experience, the IRS (and state taxing authorities, too) are far less likely to inquire into the background of a settlement if the settlement document is explicit as to tax consequences. True, the IRS and other taxing authorities can certainly do so, and they are not bound by mere recitations of tax treatment in a settlement document. Still, one ought to take one's bite of the apple if one can.

The very recent case of Wallace R. Noel, et ux. v. Commissioner, demonstrates that even if one does not address tax consequences, and even if one executes a general release, all is not lost. In that case, the Tax Court held that the proceeds a businessman received from settling a dispute with Pizza Hut, Inc. were partially excludable under Section 104. Admittedly, this case involved the pre-August 20, 1996 version of Section 104. Plus, the Court did hold that most of the proceeds were taxable as received in exchange for stock. Still, on the basis of a general release, the Tax Court did find Section 104 to apply to part of the recovery. That by itself, in the current strict climate, seems pretty remarkable.

Wallace Noel owned several Pizza Hut restaurants as a franchisee. In 1975, he transferred them to Pizza Management, Inc. in exchange for 11% of its stock. By the 1980s, Pizza Management had 200 franchised Pizza Hut restaurants, and was developing plans for a public offering of stock. Pizza Hut prevented the Pizza Management public offering, asserting that the public offering violated the franchise agreement.

As a consequence, Pizza Management's value was adversely affected. In addition, Mr. Noel personally suffered emotional distress, damages to his business reputation, and setbacks in other financial ventures. In 1988, he sued both Pizza Management and Pizza Hut, alleging that Pizza Management breached its obligations to him, and that Pizza Hut tortiously interfered with his contractual rights and prospective business ventures. The suit was settled in 1990, with Noel transferring all his Pizza Management stock to Pizza Hut in exchange for $3.2 million.

On his 1990 return, Mr. Noel treated $2 million of the proceeds as the amount he received for his Pizza Management shares (which had a $5 per share book value). He treated the remaining $1.2 million as an amount received in exchange for a release of claims excludable under Section 104. Predictably, the IRS determined that no part of the $1.2 million was excludable from income. The Service also concluded that Noel's basis in his Pizza Management stock was $200,000 rather than the $1.5 million that he claimed.

Court Unravels It

The Tax Court noted that the settlement agreement and release did not specify what portion of the $3.2 million in proceeds were paid to Noel for the release of claims as opposed to the sale of the stock. As such, the Tax Court felt that its obligation was to determine the intent of the payor in making the payment. Despite the testimony of Pizza Hut through its representatives that all of the proceeds represented a payment for Mr. Noel's stock, Judge Fay found that Pizza Hut paid Noel to purchase his stock and to settle his claims. The court emphasized that the release was not merely a general release, and that Pizza Hut would not have purchased Noel's stock without also getting a release. This kind of "but for" analysis enabled the court to come the conclusion that at least some portion of the recovery ought to relate to personal injury damages.

But what portion, that was the question. The court allocated $2.4 million of the settlement proceeds to the stock purchase, concluding that Noel sold 400,000 shares at $6 per share. Of the remaining $880,000 in proceeds, the court concluded that one- third (or $295,000) was paid to Noel to settle tort claims and was therefore excludable under Section 104. However, the remaining two-thirds of the proceeds represented nonexcludable proceeds to settle Noel's contract claims.

Faced with a general release, the Tax Court went into a kind of nitty-gritty analysis about just how many claims Mr. Noel had and what they were. The court had no trouble (despite an appallingly general document) in segregating the stock sales proceeds from the release payments. The court then further bifurcated the release payments between the torts and excludable release payments and the ones that were for contract claims and therefore constituted taxable income.

Turning to Mr. Noel's basis in his Pizza Management stock, Judge Fay agreed with the IRS that most of the adjustments to stock basis Noel claimed were not allowable. However, the court held that Mr. Noel properly included in basis $219,000 of the $300,000 in attorneys' fees he paid in the Pizza Management/Pizza Hut dispute. According to the court, because 73% of the proceeds were allocated to the Pizza Management stock purchase, that proportion of the attorneys' fees was allocable to the stock's basis. On the remaining attorneys' fees, the portion attributable to the tort claim was not deductible under Section 265, and could not be allocated as basis. The remaining $54,000 that represented the settlement of the contract claim was deductible as a miscellaneous itemized deduction.

Turning lastly to penalties, the court did not sustain the accuracy-related penalty against Noel, finding that he reasonably relied on his accountant's advise to exclude a portion of the settlement proceeds under Section 104.

Lessons Learned

Failing to explicitly address tax consequences can be a substantive disaster, fomenting further litigation. Plus, it can even more readily foul up intended tax treatment. It is perhaps a mistake to make too much of the Wallace R. Noel case. At the same time, those of us who seem always to be advocating using detailed settlement agreements cannot help but look somewhat askance at the relative degree of success obtained in this case, notwithstanding very generalized documents.

After all, although it is not necessarily a good idea to wait for the IRS or Tax Court to try to determine the intent of the payor and just what certain amounts ought to be allocated to, if one has a general release or general sale agreement, perhaps there is little choice. It is still true that the settlement document itself represents only a manifestation of the intent of the payor and an agreement of the parties, one that is not binding. Yet it is precisely in that document that such nitty-gritty items as 1099s and such can be handled and specify clearly. Failing to do so sometimes gives rise to nasty disputes (witness the "you breached my settlement agreement" argument raised in the Bowden case above).

In any event, while Wallace R. Noel may not be a super victory for taxpayers on the sheer numbers, in this increasingly hostile environment to Section 104 exclusions, it is significant that despite what appears to be any planning in the settlement agreement, Mr. Noel did achieve a partial Section 104 exclusion in Tax Court. That leads one to question how successful he might have been had he addressed the issue earlier on!

Attorneys' Fees

The tax treatment of attorneys' fees in contingent fee situations is particularly onerous if the plaintiff can only deduct the attorneys' fees as miscellaneous itemized deductions. That is the case in the overwhelming majority of situations simply because the plaintiff's case normally does not arise out of a trade or business. If it did, it could go on a Schedule C and not be subject to the alternative minimum tax, nor the phase-out of miscellaneous deductions, the 2% floor on miscellaneous itemized deductions, etc.

Recently, the Sixth Circuit Court of Appeals reversed a district court decision to find that an amount of attorneys' fees paid from a personal injury judgment did not constitute taxable income to the plaintiff. As with all cases in this area, the precise facts are truly important, something that many commentators have (oddly) not noted about this entire area. And that means there's still some room for planning, even if one is in one of the "bad circuits" that has not been friendly to the taxpayer on these issues.

The case is Estate of Arthur L. Clarks v. United States. The case concerned Mr. Clarks who received a $5.6 million jury verdict for personal injury damages against K-Mart way back in 1988. In 1991, K-Mart paid him $11.3 million, which included $5.7 million in interest. Of the $11.3 million, $3.7 million (including $1.9 million in interest) was paid directly to Clarks' attorney under the terms of a contingent fee agreement.

Mr. Clarks died in 1992. His estate filed a 1991 income tax return, but did not include as income any portion of the interest paid to the attorney. The IRS determined a deficiency which the estate paid. The estate then claimed a refund, arguing that the interest portion of the attorneys' fees was not taxable to Clarks. After all, argued the estate, Clarks never received that portion of the funds. The district court felt strongly about this issue (in favor of the government) and granted the government's motion for summary judgment.

Reasonableness on Appeal

The Sixth Circuit, however, took a longer look at the situation. The Sixth Circuit held that the interest paid to Clarks' attorney was not taxable income to Mr. Clarks because it was actually earned by Clarks' attorney. Citing (you guessed it!) Cotnam v. Commissioner, the Sixth Circuit explained that the contingent fee agreement constituted an assignment of a portion of the judgment sought to be recovered. This transferred ownership of a part of Clarks' claim to his attorney, said the court. Clarks released his right to a portion of the claim, so the amount that Clarks' attorney received with respect to that portion did not constitute income to Clarks. (Obviously, it did constitute income to the attorney.)

Cotnam Analysis

There has been a great deal of talk in the recent case law (especially in circuits dismissing the Cotnam authority out of hand), that this authority is simply outdated, is peculiar to Alabama law, etc. But the Sixth Circuit honestly attempts to take the Cotnam authority on, examining it against other established case law. Judge Merrit of the Sixth Circuit distinguished Cotnam from another even more famous tax case, Lucas v. Earl, and an equally famous case, Helvering v. Horst.

In those now ancient cases, the taxpayers assigned their income to family members. The taxpayers in Lucas and Horst were considered to have taxable income even though they never actually received the income because the income was already earned, vested and relatively certain to be paid to the assignor before any assignment was made. Thus, these cases, thus, invented the "assignment of income" doctrine.

In the Sixth Circuit in Estate of Arthur Clarks, however, the situation was different. In Lucas v. Earl and in Helvering v. Horst, the income had a tangible known value to the assignors, and the assignees (family members) did not perform any services to receive the income. In contrast, Mr. Clarks did not have a predetermined interest in any tangible funds before he entered into the fee agreement with his attorney. Given the speculative nature of the lawsuit, Judge Merrit reasoned, Mr. Clarks' claim simply constituted an intangible, contingent expectancy. The only economic benefit Mr. Clarks derived from his claim amounted to a portion of the total judgment he received as a result of his attorney's efforts.

This discussion, of course, might be applied across the full range of litigation. After all, is the Sixth Circuit saying that one must examine the speculative nature of this particular lawsuit, or isn't any lawsuit speculative in nature? That's a difficult question to judge. In virtually any lawsuit, one can say that the only economic benefit the plaintiff expects to receive will be derived from the efforts of his or her attorney.

Continuing to distinguish the assignment of income cases, Judge Merrit of the Sixth Circuit also noted that, unlike the assignees in the Lucas v. Earl and Helvering v. Horst cases, Mr. Clarks' attorney performed services and the income was a result of the attorney's own skill and judgment. The attorney earned the income, said the Sixth Circuit, not the plaintiff.

Conflict Among Circuits

The presence of this sensible authority ought to cause naysayers on the issue to it up and take notice. After all, recently, the authority had not been too rosy. The Sixth Circuit in Estate of Arthur Clarks goes through the authority, commencing with Cotnam v. Commissioner, and the more recent cases thereafter. Cotnam, as most readers know, involved the Fifth Circuit holding that the amount of a contingent fee paid out of the judgment to the plaintiff's attorneys was not income to the plaintiff.

Under Alabama state law, which applied in the Cotnam case, a contingency fee contract operates as a lien on the recovery. The Alabama Code provided that attorneys at law will have the same right and power over suits, judgments and decrees to enforce their liens as their clients had or may have for the amount due. That gave the Cotnam court solid ground to say there had been a transfer of part of the plaintiff's claim and that any recovery on a portion of that claim (by the lawyers) was simply gross income to the lawyer.

The Eleventh Circuit (which was made up of a portion of the Fifth Circuit when the Fifth was split in two) followed the Cotnam result, but without any analysis. Now, the Sixth Circuit has followed the Cotnam result, too, but it did so by looking to the vicissitudes of state law.

In the case of Arthur Clarks, the relevant state law was Michigan law, and the court said that the lien law there operated in more or less the same way as the Alabama lien in Cotnam. Not surprisingly, most of the law concerning personal property liens (and attorney liens in particular) go back many years. Indeed, the Sixth Circuit had to cite a case dealing with attorneys' liens going back to 1889! The court found that these hoary cases generally supported treating the attorney as having an ownership interest in that portion of the case.

Yet, the Sixth Circuit noted that a more recent decision by the court of appeals for the Federal Circuit reached a contrary result. In Baylin v. United States, the Federal Circuit did not follow Cotnam. The Baylin court held that the contingent fee portion of the settlement from a condemnation proceeding that was paid directly to the lawyer was still income to the plaintiff taxpayer. The Baylin court mentioned the Supreme Court's liberal interpretation of "gross income," and then went on to find that even though the plaintiff never had actual possession of the funds that went to the lawyer, the plaintiff received the benefit of those funds in that they discharged an obligation the plaintiff owed to the lawyer. This is the "discharge of indebtedness" theory under which some of these cases are decided.

The Sixth Circuit in Arthur Clarks went on to analyze the Baylin court's rule. Baylin, interestingly, relied on the two early Supreme Court cases noted above, Lucas v. Earl, and Helvering v. Horst. As noted above, these cases involved assignments of income by persons who had earned the income already (but not received it physically). To make matters worse, they "assigned" the income to family members.

Hence the "assignment of income" doctrine. After going through some pains to recite the individualized facts of both the Lucas and Horst cases, the Sixth Circuit said that in both of those cases each taxpayer earned and created the right to receive and enjoy the benefit of the income before any assignment. The income assigned to the assignee was already earned, vested and relatively certain to be paid to the assignor.

The court in Estate of Arthur Clarks does a good job of distinguishing both the Lucas and Horst cases, and comes back to the notion that the Cotnam court had it right all along. After all, said the court, the majority in the Cotnam decision correctly distinguished Lucas v. Earl, and Helvering v. Horst. In the case of Mr. Clarks, as in Cotnam, the value of the taxpayer's lawsuit was entirely speculative and dependent on the services of his counsel. The claims simply amounted to an intangible, contingent expectancy.

Indeed, the only economic benefit Mr. Clarks could derive from his claim against the defendant in state court was to use the contingent part of it to help him collect the remainder. Like an interest in a partnership or a joint venture, said the court, Mr. Clarks contracted for services and assigned his lawyer a one-third interest in the "venture" in order that he might have a chance to recover the remaining two-thirds. Just as in the Cotnam case, said the Sixth Circuit, the assignments that Clarks' lawyer received operated as a lien on a portion of the judgment sought to be recovered, thus transferring ownership of that portion of the judgment (when it eventually became a judgment) to the attorney.

How Important Is This?

The Sixth Circuit has given an enormously strong endorsement of the Cotnam theory, and an equally strong statement about the scope of the assignment of income doctrine and the seminal cases (Lucas and Horst) from which all of this assignment of income phobia sprang. The assignment of income doctrine, certainly as pronounced in the Lucas and Horst cases, involved gratuitous transfers, and involved timing (after the income was earned) that was radically different from virtually all of these attorneys' fee cases.

Do you think that an attorney would work on a case based on the strength of the notion that he would receive a right to payment only once the client determined if payment was actually going to be made? The contract between client and lawyer is entered into at the very inception of the relationship—typically before the lawyer is willing to do any work to develop the case. Perhaps that is why the Sixth Circuit even mentioned the partnership theory. After firmly putting to rest (at least in my mind) the irrelevance of the Lucas and Horst lines of authority, and after firmly asserting the relevance of Cotnam, the Sixth Circuit went on to close its opinion by drawing yet another analogy.

The present transaction (Mr. Clarks' agreement to the one-third contingency fee and the events that transpired thereafter) is more like a division of property, said the court, than an assignment of income:

"Here, the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant-in-common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract. Here the lawyer's income is a result of his own personal skill and judgment, not the skill or largesse of a family member who wants to split his income to avoid taxation. The income should be charged to the one who earned it and received it not as under the government's theory of the case, the one who neither received it nor earned it. The situation is no different from the transfer of a one-third interest in real estate that is thereafter leased to a tenant." [Citations omitted.]

Supreme Court

The fact that the Fifth, Eleventh and now Sixth Circuits have held that a plaintiff is not taxable on the contingent fee portion of attorneys' fees, while other circuit courts have ruled to the contrary, heightens the conflict that already exists in the circuits. If this mess is not resolved by statute, then maybe the Supreme Court will have to rule on the question. And if it does so, my vote is with the Fifth, Eleventh and now Sixth Circuits.

Admittedly, though, the facts in many of these attorneys' fee cases varies dramatically. Advisors and taxpayers alike should be alert to some of the traps. For example, it is vitally important (for an argument to exist that the client doesn't have the income) that the fees be "direct paid" from the defendant to the attorney.

It is also vitally important that the contingent fee agreement specify in strong terms when the interest in the case is assigned. And, the attorneys' lien law in the state can be helpful. I'm not positive that the attorneys' lien law ought to be the most relevant factor, and most attorneys are not even familiar with how attorneys' liens are manifested (recorded, etc.).

This will continue to be a volatile area. Taxpayers and their advisors (and certainly litigators, too) should be awfully careful. They should obtain tax advice before the settlement is reached. They should be careful how the payments are made. Of course, they should also be careful what the settlement agreement specifies about who is going to get any 1099 or W-2 forms. The forms issue (with its audit risk controls) can have an enormous impact on the ultimate result of the case.

Reporting Attorneys' Fees

Finally, a few words about a very troubling subject, the reporting of attorneys' fees. Both inside and outside of lawyer circles, there has been a good deal of complaining about Internal Revenue Code Section 6045(f). This provision was enacted as part of the inaptly named Taxpayer Relief Act of 1997. It imposes a number of new burdens on reporting entities, and ostensibly new burdens on recipients of attorneys' fees.

Strangely enough, Section 6045(f) was not widely noticed when it was first enacted. Perhaps because it was enacted in 1997 but did not take effect for payments commencing in 1998, it was not until the beginning of 1999 — when Form 1099 reports were prepared for the 1998 tax year — that people began to sit up and take notice about the new burdens and risks this Code section proffered.

Proposed Regulations Issued, Then Delayed

The proposed Treasury Regulations under §6045(f) went a long way toward making those who were not otherwise aware of the situation become aware. Happily, they did not carry a retroactive effective date, so many commentator groups, including the American Bar Association, the American Institute of Certified Public Accountants, Tax Executives Institute, and various other groups, attacked the provisions as being overbroad, under-explanatory, and confusing in a number of respects.

Since the general reaction to a Form 1099 filing obligation on the part of most taxpayers is to err on the side of caution (in other words, to send a 1099 Form when in doubt), there has understandably been fear that the complex web of this reporting obligation would be expanded even further than these proposed regulations seek to do.

The IRS announced in Notice 99-53, that the effective date for the proposed attorney reporting regs was delayed for one year. These regs (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 means we all have a bit of breathing room to attempt to convince the Service that it needs to revise some of these rules.

Yet, the Notice 99-53 is quite clear that payments of gross proceeds to attorneys made after December 31, 1997 are now (and continue to be) reportable on Form 1099-MISC. This was accomplished merely by the enactment of §6045(f), and needs no regulatory explanation. Of course, TEI does point out (as have others), that some of the rules having nothing to do with withholding are quite bazaar. For example, few commentators fail to miss the fact that if separate checks are made out to attorney and plaintiff for separate amounts, one would think separate Form 1099s could be called for in the respective amounts paid to each. But surprise! The mere fact that the client's check is delivered to the attorney's office will require the payor to issue a Form 1099 to the attorney for the full amount (both the amount paid to the attorney and the amount "separately paid" to the client). These and other glitches deserve repeated comment by taxpayers and their representatives.