

A Lawyer's Guide To Navigating 1099s

By Robert W. Wood

No one likes receiving Internal Revenue Service Forms 1099, those pesky little tax forms you receive this time of year to report last year's income. Issuing them isn't any fun either, but there are penalties for failing to do so. Most of the penalties are relatively small, which makes their impact primarily in the case of repetitive or mass failures.

Suppose you distribute class action checks to thousands of plaintiffs, but you forget to issue the Forms 1099. An IRS penalty of \$260 per form is small if you skip a few forms, but if you skip thousands, \$260 per form can add up fast. Moreover, there is also a penalty of 10 percent of the amount involved in the case of intentional failures to issue the forms.

For that reason, many businesses — including lawyers and law firms — go overboard issuing the forms. The IRS probably likes that. Recipients of Forms 1099 do not.

Forms 1099 are issued by businesses (including law firms) every January for the preceding calendar year. Forms 1099 must be mailed to taxpayers no later than Jan. 31 for the preceding year. Copies must be sent to the IRS no later than the end of February.

The forms allow computer matching of Social Security numbers. There are many types, including Form 1099-INT for interest; 1099-DIV for dividends; 1099-G for state and local tax refunds and unemployment benefits; 1099-R for pensions; 1099-B for broker transactions and barter exchanges; 1099-S for real estate transactions, etc. The general threshold is \$600, and one of the most common forms is 1099-MISC for miscellaneous payments, including nonemployee compensation and other income.

If you are ever tempted not to report something, receiving a Form 1099 may keep that temptation in check. Omit even a small amount of income reported on a Form 1099, say \$200 of interest or a \$1,000 consulting fee you received, and you'll get a letter from the IRS asking for tax on that amount.

The basic reporting rule is that each person in business who pays \$600 or more for services must report it on a Form 1099. Lawyers and law firms must issue Form 1099 to expert witnesses, contract lawyers, jury consultants, investigators and co-counsel where services are performed and the payment is \$600 or more. Payments during the year are aggregated. If you pay an investigator \$500 and then another \$500 later the same year, you must issue a Form 1099.

A notable exception to these rules is for payments to corporations. A payment to a corporation for services is generally exempt. That means if you pay an individual or LLC court reporter \$1,000, you must issue a Form 1099. If the court reporter is incorporated, the form is not required.

However, there's an *exception to the exception* for payments to lawyers and law firms. Even payments for services to incorporated law firms trigger a Form 1099. (Gee, perhaps the IRS doesn't trust that lawyers will report their income?) So a lawyer or law firm paying fees to incorporated co-counsel, or a referral fee to an incorporated lawyer, must issue a Form 1099.

Furthermore, a client in business that pays a lawyer or law firm more than \$600 in a year — even if incorporated — should issue a Form 1099. Should lawyers ever *issue* Forms 1099 to clients? Practice varies, but most lawyers do not need to issue a Form 1099 to their client for settlement monies.

The reason is that lawyers receiving a joint settlement check to resolve a client lawsuit are usually not considered payors of the

money. The settling *defendant* has the obligation to issue the forms, not the lawyer.

Take this example: Larry Lawyer earns a contingent fee by helping Cathy Client sue her bank. The settlement check is payable jointly to Larry and Cathy. If the bank doesn't know about this payment split, it must issue a Form 1099 to both Larry and Cathy, each for the full amount. When Larry cuts Cathy a check for her share, he need not issue a form.

Now take this example: Suppose Larry tells the bank to issue two checks, one to Larry for 40 percent, the other to Cathy for 60 percent. Obviously, again Larry has no obligation to issue a form — Cathy is getting paid by the bank. The bank will issue Larry a Form 1099 for his 40 percent. It will issue Cathy a Form 1099 for 100 percent, including the payment to Larry — even though the bank paid Larry directly. Cathy will have to find a way to deduct the legal fee.

The primary circumstance in which lawyers must issue the forms to clients is if the lawyer exercises significant oversight and management. Under IRS regulations, if lawyers exercise management and oversight of client monies, they become "payors." That means they can be required to issue Forms 1099 when they disburse funds.

What if you're not sure or make a mistake? The IRS cares a lot about these forms. Most penalties are modest, \$260 per form you fail to file. But this penalty is for non-intentional failures. In some cases, if you fail to issue a required Form 1099, the IRS may try to deny a tax deduction for the item that should have been reported.

That means if you fail to issue a Form 1099 for a \$100,000 consulting fee, the IRS could claim it is non-deductible. Another danger is the penalty for intentional violations. If you know you must issue a Form 1099 but ignore that obligation, the IRS can slap you with a penalty equal to 10 percent of the amount of the payment. That means a \$400,000 payment for which you fail to issue a required Form 1099 could trigger a \$40,000 penalty.

Finally, these rules can impact the worker status arena too. Suppose you fail to issue Forms 1099 to jury consultants or contract lawyers you have pay as independent contractors. The IRS can use that failure as evidence that they are *really* your employees. This can bring potential failure to withhold tax responsibilities, as well as other penalties.

As a corollary to Form 1099 rules, attorneys must promptly supply their taxpayer identification numbers to persons who are required to prepare these forms. Attorneys may often be asked for their own (or their firm's) taxpayer identification number, and that of their client, for purposes of reporting settlement monies. Most requests come on IRS Form W-9.

Usually, you can't fight it, so don't try. If an attorney fails to provide the taxpayer identification number to a paying party, the IRS can impose a \$50 penalty for each failure to supply that information. The payments could also be subject to back-up withholding, meaning that the defendant could send 28 percent of the money to the IRS. Some defendants may even refuse to disburse settlement monies.

Form 1099 time is stressful for everyone, whether you are a recipient, an issuer, or both. Remember, these are consequential forms. They do not *necessarily* mean that the reported amount constitutes income to you. For example, a Form 1099-MISC that reports "gross proceeds paid to an attorney" are reporting that. Some, all, or none of those proceeds may be income to you.

Every year, clients with serious physical injuries receive Forms 1099 for their settlements, even though IRS regulations say that a tax-free physical injury award is not supposed to be the subject of a Form

1099. The Form 1099 does not mean that the injured plaintiff must pay tax on an award that is excludable. But it sure means the plaintiff needs to report the payment on his tax return and explain why it should not be taxed.

In short, the presumption in most cases is that getting a Form 1099 means taxable income. So keep track of them carefully. Especially if you get into a tax dispute, you'll be glad you did.



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