

Credit Cards, Law Firms And The IRS

By Robert W. Wood

There may have been a time when blue blood law firms didn't take credit cards. These days, however, most lawyers are happy to get paid via check, credit card or even cash. The rules for accepting payments in cash haven't changed in decades. You must issue a form to the Internal Revenue Service reporting any transaction with more than \$10,000 of cash.

Credit card rules, though, have changed significantly. We all know that accepting credit cards incurs a cost via a discount the bank or processing company charges the law firm as the merchant. Discount rates vary, but if a lawyer accepts a client's American Express card for a \$10,000 legal bill, the lawyer may net only \$9,600 into his or her bank account.

However, what about tax reporting should the lawyer know? First, distinguish between the regular Form 1099 rules. Clients issue lawyers and law firms Forms 1099 for payments of services totaling more than \$600 each year.

For many years, payments to corporations were exempt from Form 1099 reporting. In 1997, that changed with a new tax code section (6045(f)) requiring all payments to lawyers and law firms for services to be subject to Form 1099 reporting. This Form 1099 is required even if the law firm is incorporated. In effect, the "Issue a Form 1099 to every lawyer" rule trumps the rule that one need not issue Forms 1099 to corporations.

Lawyers who pay independent contractors, co-counsel, etc. over \$600 are to issue Forms 1099 for payments. Every lawyer and law firm should monitor compliance with issuing Forms 1099. In some cases, even clients should be issued the forms — and that's a topic I'll address in a future column.

That brings us to credit cards. In 2008, Congress added Section 6050W to the tax code requiring merchants and third-party settlement companies to issue Forms 1099 reporting all credit card transactions. After a phase-in period, the rules went into effect Jan. 1, 2012. The new form is a 1099-K, and all lawyers and firms taking credit cards should beware of it.

It works like this: Suppose that your law firm accepts MasterCard, Visa and American Express payments for hundreds of clients over the course of a year. You may use one credit card processing company or several. Each credit card processing company and each third-party payment aggregator must now issue your firm a Form 1099-K reporting the total amount processed.

That doesn't seem so bad, right? You have to report the payments as income anyway, so where's the harm? The potential harm comes in several ways.

First, this is gross payment reporting, not net. The IRS will be told you received the total of the full charge, not the net amount you actually received. If the discount your processing company charges you on credit cards is 4 percent, you really only get 96 percent of the fees in your bank account.

Yet the Form 1099-K will report 100 percent of the income. Of course, you must simply keep track of the discount and deduct it on your firm's return. More troubling is the trust account rule. The credit card processing companies and the reporting law do not distinguish between trust accounts and general or operating accounts.

Are payments into your trust account income? Not necessarily. Under the tax law, if you accept retainers via credit card or via check, the retainer is not income until you earn it. When you earn it depends on the nature of your retainers. If your retainers are true retainers and you bill legal fees against them and earn fees as you bill them, then the unearned retainer is not income. If the retainer is nonrefundable and earned when you receive it, then it is income in full upon receipt.

Suppose that you accept a retainer at the commencement of a case and earn only half of it before the end of the year. Here, you have only that portion of earned income to report. Nevertheless, the credit card company will tell the IRS you *received it all*.

Once again, this should not be a major problem for the law firm's or lawyer's tax return. Yet any time the law firm or lawyer receives Forms 1099 reporting amounts that are beyond actual income, some explanation is appropriate on the tax return. A larger issue relates to matching.

Section 6050W requires credit card processors to verify and match your federal Taxpayer Identification Number and your legal name to IRS records. Lawyer or law firm names on merchant card accounts are often different, abbreviated or an acronym. It is appropriate to check this and if needed to conform these items with your credit card processor.

There are penalties if you do not. The IRS can impose a 28 percent withholding penalty on credit card transactions if the merchant information on file is not an exact match with IRS records. If lawyers need an incentive to contact their credit card processor(s) to make sure everything is in order, this is it.

Now the good news. Many lawyers and law firm administrators may see this new tax law as another respect in which lawyers have to endure tough, arguably unnecessary compliance and reporting. However, there is a bit of silver lining in this cloud.

Section 6050W states that processors cannot charge for implementing the Form 1099-K process. Banks and credit card processing companies are well versed in trying to pass along to customers the costs of various items, sometimes obliquely. Thus, it may be worth verifying that you are not being charged for anything new, including a fee for matching for name and Taxpayer Identification Number.

Tax advisers are likely to differ in their approaches to explaining discrepancies between amounts reported on Forms 1099 and income for tax purposes. Some may favor detailed explanations and reconciliations. Some may favor minimal or no explanation. Although the Form 1099-K issue is new, "gross proceeds" Forms 1099 have been around for years. Thus, the issue is not new. Indeed, many lawyers and law firms have been receiving Forms 1099 reporting far more than the amount of their actual income since 1997.

As one example, if a plaintiff attorney receives a personal injury settlement via joint check, the lawyer will receive a Form 1099-MISC reporting the gross proceeds. This is so even though only a third or 40 percent may actually be income to the lawyer. In that sense, the new rule credit card reporting is simply more of the same. However, there are indications that more of an explanation may be warranted between amounts reported to the IRS and the actual income of the lawyer or law firm income. See IRS Clarification to the Instructions for Schedule C, E, & F (Form 1040) on Reporting Form 1099-K Amounts.

Lawyers and law firms should discuss these issues with their own tax adviser. In past years, lawyers were targeted by the IRS with the now infamous "Project Esquire" to ferret out unreported income. There is little to suggest that this is occurring again. At the same time, lawyers may feel particularly vulnerable to IRS and Franchise Tax Board tax audits and scrutiny. The stakes can be large.



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