

IRS FORM 1099 | Ten things every lawyer should know

By Robert W. Wood

Everyone receives IRS Forms 1099 every year. These little forms report interest, dividends, real estate sales proceeds, consulting income, retirement plan distributions, tax refunds, and many other categories of income. They are a major source of information for the IRS. Copies go to state tax authorities too and they are equally useful in collecting state tax revenues.

In fact, these little forms represent the keys to the kingdom, allowing matching of taxpayer identification numbers and dollar amounts. That means there is a stark certainty about them.

If you receive a Form 1099 reporting income but fail to put it on your tax return, you will almost certainly receive a tax notice (or worse).

Because Forms 1099 allow computer matching of Social Security numbers and dollar amounts, the forms have a decided impact on tax compliance and collections. IRS statistics prove this. When a taxpayer receive one of these forms he or she is much more likely to report the payment on a tax return.

The forms also encourage efficiency in tax collections. IRS collection efforts can be streamlined, even mechanized. It takes no effort for the IRS to spew out a bill to a taxpayer who fails to include a payment reported on a Form 1099.

Forms 1099 should never be ignored and should be opened promptly. There are many more Forms 1099 today than ever before. That means there are also more errors. Many errors can be corrected if you act promptly, so open them upon receipt.

Do not wait until you start to do your taxes.

Kill All the Lawyers?

Lawyers receive and send more Forms 1099 than most people, in part due to tax laws that single them out. Several decades ago the IRS initiated a program called "Project Esquire," which implicitly recognized that lawyers needed particular tax scrutiny.¹ This program was long ago suspended. Nevertheless, some at the IRS still believe lawyers deserve special audits. A recent IRS audit guide instructs IRS agents what to look for when auditing lawyers.²

Lawyers make good audit subjects because they often handle client funds. They also tend to have significant income. Independently, the IRS has long had an interest in the tax treatment of litigation settlements, judgments and attorney fees. These concerns coalesce nicely in reporting issues over attorney fees. For this reason, it should be no surprise that lawyers are singled out for extra Forms 1099.

Following a tradition of naming tax legislation with euphemisms, Congress included a host of tough tax laws in the ironically named "Taxpayer Relief Act of 1997." One provision that captivated attorneys was a seemingly innocuous reporting rule now enshrined in Section 6045(f) of the tax code. That provision requires companies making payments to attorneys for services to report the payments to the IRS on a Form 1099.

On its face, this may not seem like an important provision in the tax law. After all, regardless of whether they receive Forms 1099, lawyers should report all

their fee income. Yet this rule has a significant impact on lawyers as recipients and as issuers of Forms 1099. Lawyers and law firms send as well as receive them.

In fact, these little slips of paper have become ubiquitous in law practice, and their relevance is not confined to once a year at tax time. Even for lawyers who have an accountant or bookkeeper to keep them straight, any lawyer in private practice—whether in a large firm, small firm or solo practice—should know key facts about them. In-house lawyers who deal with settlements of suits against their company also need to know the basics of Form 1099 rules.

Here are ten things every lawyer should know:

1. \$600 or More

The basic reporting rule is that each person engaged in business and making a payment of \$600 or more for services must report it on a Form 1099. 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 where services are performed and the payment is \$600 or more.

A notable exception from the normal \$600 rule is payments to corporations. Payments made to a corporation for services are generally exempt. But see rule 2 below.

2. Incorporated Lawyers

Although payments to corporations are

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1 The IRS undertook Project Esquire during the 1990s to identify attorneys who failed to file federal income tax returns. Although most were given the opportunity to pay their taxes, some were criminally indicted. See "Attorney Nonfilers Still Targets in Service's Project Esquire," 95 TNT 52-7 (Mar. 16, 1995).

2 See Robert W. Wood, "What Every Lawyer Should Know About IRS Audits," Vol. 83, No. 8, New York State Bar Association Journal (Oct. 2011), p. 36; see also IRS Attorneys Audit Technique Guide (March 2011), available at <http://www.irs.gov/businesses/small/article/0,,id=241098,00.html>.

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exempt from 1099 rules, an exception applies to payments for legal services. Put another way, the rule that payments to lawyers must be the subject of a Form 1099 trumps the rule that payments to corporation need not be. Thus, any payment for services of \$600 or more to a lawyer or law firm must be the subject of a Form 1099. It does not matter if the law firm is a corporation, LLC, LLP or general partnership.

It also does not matter how large or small the law firm. This impacts law firms as issuers of Forms 1099 as well as receiving them. 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.

3. Timing.

IRS Forms 1099 are generally issued in January of the year after payment. They must be dispatched to the taxpayer by the last day of January. The IRS copies are not due at the IRS until the end of February (along with a transmittal form summarizing the data).

For that reason, after sending the forms to payees, most businesses wait a few weeks before sending the required copies to the IRS. In part, this is to allow for corrections. If someone receives a Form 1099 and promptly complains to the issuer, the correction can readily be made without needing to file multiple Forms with the IRS to correct the error.

Some businesses and law firms prefer to issue Forms 1099 at the time they issue checks. This practice is perfectly lawful and seems to be growing in popularity.

Example: Suits-R-Us, LLP is disbursing \$1,500 each to thousands of plaintiffs in a consumer class action. Seeking to economize and only prepare one mailing to class members, the firm issues the checks and Forms 1099 to class members simultaneously. In February of the following year it will transmit all the Forms 1099 and summary data to the IRS.

4. Forms 1099 to Clients?

One of the most confusing tax reporting issues for law firms is whether the law firm should issue Forms 1099 to clients. Practice varies considerably, and many firms issue the forms routinely.³ However, most payments to clients do not require the forms.

Settlement Checks to Clients? Many lawyers receive funds which they pass along to their clients. There is rarely a Form 1099 obligation for such payments. Most lawyers receiving a joint settlement check to resolve a client lawsuit are not considered payors. The settling defendant is considered the payor, so it has the obligation to issue the forms, not the lawyer.

Example 1: 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 the Larry/Cathy split, it must issue two Forms 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.

Example 2: Consider the same facts as in Example 1. However, suppose that Larry tells the bank to issue two checks, one to Larry for 40%, and the other to Cathy for 60%. Here again Larry has no obligation to issue a form, because Cathy is getting paid by the bank. The bank will issue Larry a Form 1099 for his 40%. It will issue Cathy a Form 1099 for 100%, including the payment to Larry—even though the bank paid Larry directly. Cathy will have to find a way to deduct the legal fee.

Personal Physical Injury Payments.

One of the many exceptions to the rules for Forms 1099 applies to payments for personal physical injuries or sickness. Because such payments are tax-free to the injured person, no Form 1099 is required.

Example 1: Hal Hurt is in a car crash and receives a \$1 million settlement. Defendant Motors issues a joint check to Hal and his lawyer Sue Suits. Defendant is not

required to issue a Form 1099 to Hal. Defendant must still issue a Form 1099 to Sue for the full \$1 million.

Example 2: Same facts but this time Sue asks for a \$600,000 check issued to Hal (no Form 1099) and a \$400,000 check issued to her (Form 1099 to Sue for \$400,000).

Other Payments to Clients. Refunds of legal fees to clients raise another issue. If the refund is of monies held in the lawyer's trust account, no Form 1099 is required. However, if the law firm was previously paid and is refunding an amount from the law firm's own income, a Form 1099 is needed.

Example: Big Law LLP represents Joe Inventor and is holding \$50,000 of Joe's funds in its trust account. Due to a dispute over the quality of Big Law's services, it agrees to refund \$30,000 of Joe's deposit. No Form 1099 is required, since this was Joe's money. Big Law also agrees to refund \$60,000 of the monies Joe paid for fees over the last three years. Big Law is required to issue a Form 1099 for the \$60,000.

5. Oversight and Management?

The primary area where lawyers must issue the forms to clients is if the lawyer performs significant oversight and management functions. What if the lawyer is not merely receiving the money and dividing the lawyer's and client's shares? Under IRS regulations, if lawyers take on too big a role and exercise management and oversight of client monies, they become payors. As such, they are required to issue Forms 1099 when they disburse funds.

6. Beware Joint Payees

IRS regulations contain extensive provisions governing joint checks. Most of these rules mean that lawyers will be receiving the forms.

Example: Dastardly Defendant settles a case and issues a joint check to Clyde Client and Alice

3 See Rule 7 about when in doubt, issue the forms.

Attorney. Dastardly normally must issue one Form 1099 to Clyde for the full amount and one Form 1099 to Alice also for the full amount. This reality may cause Alice to prefer separate checks. That way she will only receive a Form 1099 for her fees, not also for her client's money.

Example: This time Dastardly Defendant issues a check for 60% of the settlement to Clyde Client and 40% to Alice Attorney. Dastardly issues one Form 1099 to Clyde for 100% and one Form 1099 to Alice for 40%. So that Clyde doesn't pay taxes on the fees paid to Alice for which he received a Form 1099, he will deduct the 40% on his tax return.⁴

Seeking to help their clients avoid receiving Forms 1099, some plaintiff lawyers ask the defendant for one check payable to the "Jones Law Firm Trust Account." Treasury Regulations treat this just like a joint check, so two Forms 1099 each in the full amount are required.

7. Err on the Side of Issuing Forms

Requirements to issue Forms 1099 have existed in the tax code and parallel state law for decades. Still, these requirements have become more rigorous in recent years. Penalty enforcement has also gotten tougher. More and more reporting is now required, and lawyers and law firms face not only the basic rules but the special rules targeting legal fees.

Lawyers are not always required to issue Forms 1099, especially to clients. Nevertheless, the IRS is unlikely to criticize anyone for issuing more of the ubiquitous little forms. In fact, in the IRS' view, the more Forms 1099 the better. Perhaps for that reason, it is becoming common for law firms to issue Forms 1099 to clients even where they are not strictly necessary.

8. Penalties for Failures

However you practice, it pays to review these rules and be careful. The IRS cares a great deal about these forms. Most penalties for non-intentional failures to file are modest—as small as \$50 per form you fail to file.

This penalty for failure to file Form 1099 is aimed primarily at large-scale failures, such as where a bank fails to issue thousands of the forms to account holders. However, law firms should be careful about these rules too. The distribution of the proceeds of a class action, for example, can trigger large-scale issuances of Forms 1099.

In addition to the \$50 per failure penalty, the IRS may also try to deny a deduction for the item that should have been reported on a Form 1099. That means if you fail to issue a Form for a \$100,000 consulting fee, the IRS could claim it is non-deductible. It is usually possible to defeat this kind of draconian

penalty, but the severity of the threat still makes it a potent one.

Another danger is the penalty for intentional violations. A taxpayer who knows that a Form 1099 is required to be issued and nevertheless ignores that obligation is asking for trouble. The IRS can impose a penalty equal to 10% of the amount of the payment.

Example: Larry Lawyer makes a \$400,000 payment to co-counsel but Larry fails to issue a required Form 1099, even though his CPA told him he was required to. In addition to other remedies, the IRS can impose a \$40,000 penalty.

9. Independent Contractor vs. Employee?

The reach of the Form 1099 rules is surprisingly broad. For example, it can impact the worker status arena.

Example: Alvin Advocate fails to issue Forms 1099 to jury consultants and contract lawyers Alvin paid on an independent contractor basis. In addition to other remedies, the IRS can use Alvin's failure to issue them Forms 1099 as evidence that they are really Alvin's employees not independent contractors. This can trigger tax withholding responsibilities and a host of other penalties and liabilities.

10. Supplying Form W-9.

Since Forms 1099 require taxpayer identification numbers, attorneys are commonly asked to supply payors with their own taxpayer identification numbers and those of their clients. Usually such requests come on IRS Form W-9. If an attorney is requested to provide a taxpayer identification number and fails to provide it to a paying party, he or she

is subject to a \$50 penalty for each failure to supply that information. The payments to be made to the attorney may also be subject to back-up withholding.

Moreover, as a practical matter, some defendants may simply refuse to pay over the money without the required taxpayer identification numbers or will seek to pay the money into a court.

Conclusion

No one likes receiving Forms 1099. Most people do not particularly like issuing them either. Still, lawyers need to pay special attention to these rules. More than many other business and professional people, lawyers are commonly sending and receiving Forms 1099. The IRS is watching.

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⁴ Note however, that this deduction may be a miscellaneous itemized deduction and thus may trigger alternative minimum tax. See Robert W. Wood "AMT Problems For Attorney Fees Remain," Forbes.com (Dec. 22, 2010), available at http://WoodLLP.com/Publications/Articles/pdf/AMT_Problems.pdf.