

To 1099 or Not to 1099 – that is the (January) Question!
Primer on 1099 Reporting for Tax Year 2013
Webinar, January 9, 2014

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I. Background – 1099 Reporting.

A. Section 6041.

Section 6041 of the Internal Revenue Code generally requires every person (payor) engaged in a trade or business who makes payments aggregating \$600 or more in any taxable year to another person (payee) in the course of the payor's trade or business to file an information return with the IRS (with copy to the payee), unless the payment or payee is otherwise exempted.

- Law firms – whether organized as a sole proprietorship, partnership or corporation – are "engaged in a trade or business" of practicing law and thereby subject to the provisions of Section 6041.
- "Payments aggregating \$600 or more in any taxable year" means if the payee receives three \$100 checks from the firm's business bank account and three \$100 checks via the firm's client trust account, then the six payments aggregating \$600 are reportable, unless the payment or payee is otherwise exempt. [Note 1: It does not matter whether the client trust account bears the law firm's taxpayer identification number or that of an IOLTA-type entity. If the bank account is used by the law firm as part of its trade or business, then payments flowing through that bank account must be aggregated and included for purposes of Section 6041. Note 2: the rule is \$10 or more for payments of interest or dividends. See, Paragraphs II.A and II.]
- The payments are not reportable unless made "in the course of the law firm's trade or business." [See various Examples in Paragraphs II.C, III and IV.]
- An "information return" provides data to the IRS but does not compute the tax liability.
- For examples of "payments or payee ... exempted" from the reporting requirements, see Paragraphs IIB, III and IV.

B. Forms 1099

The IRS Form 1099 series of documents are informational returns used to report various types of income paid by payors to payees mandated under Section 6041. Law firm payors will primarily use Forms 1099-MISC, 1099-INT and possibly 1099-DIV.

C. Form W-9.

Form W-9 is used by payors to collect information from payees required to be included on Form 1099. The information includes the payee's: (i) name; (ii) federal tax classification; (iii) mailing address; and (iv) social security number or taxpayer identification number. Knowledge of the payee's federal tax classification is an essential element in determining whether payments must be reported on Form 1099. [See Paragraph II.B.] With respect to the federal tax classification, the payee has the following reporting options on Form W-9:

- | | |
|-------------------------------|--|
| 1) Individual/sole proprietor | 6) Limited Liability Company/C Corporation |
| 2) C Corporation | 7) Limited Liability Company/S Corporation |
| 3) S Corporation | 8) Limited Liability Company/Partnership |
| 4) Partnership | 9) Exempt |
| 5) Trust/estate | |

II. 1099 or No 1099?

A. Aggregate Payments

1) Interest Payments \geq \$10

- a. **IOLTA Interest** – No 1099 reporting is required with respect to interest earned in IOLTA-type bank accounts.
- b. **Interest on Other Client Trust Account Balances** – Interest earned on monies held in a client trust account and credited to the various clients' account balances are reported on Form 1099-INT.
- c. **Interest Payments to W-2 Employees** – Interest payments to shareholder-employees are reportable on Form 1099-INT.
- d. **Interest Payments to Partners** – So-called "interest payments" to partners or members of a limited liability company with a "partnership" federal tax classification are reportable on Schedule K-1, not on Form 1099-INT.

2) Dividend Payments \geq \$10 – If your firm is a corporation and pays dividends or makes other distributions on stock to shareholder-employees, then such payments are reportable on Form 1099-DIV.

3) All Other Payments \geq \$600 – 1099 reporting is required for payees with aggregate payments of \$600 or more, provided that the payee is not exempt – see Paragraph II.B – and provided the payee provides "services" to payor in connection with payor's trade or business. If the payee's aggregate payments for the tax year are less than \$600, then no 1099 reporting is required.

B. Exempt Payees/Payments

- 1) Credit Card Merchants** – No 1099 reporting is required for payments made via credit card or for payments to credit card merchants.
- 2) Government Entities** – No 1099 reporting is required for payments to federal, state and local governments.

- 3) **Compensation to Partners and Employees** – Compensation is reported on Form W-2 or Schedule K-1, not Form 1099; although interest payments to shareholder-employees is separately reportable on Form 1099-INT.
- 4) **Reimbursements** – No 1099 reporting is required for reimbursement payments substantiated by original receipts. This applies to reimbursements made both (i) to partners and employees and (ii) to third party payees who provide “services” to payor. [See Paragraph II, Example 3.]
- 5) **Certain Federal Tax Classification Providers** – No 1099 reporting is required for payees with W-9 forms on file with (or known to payor to have) federal tax classifications of:
 - a. C Corporation;
 - b. S Corporation;
 - c. Trust/estate;
 - d. Limited Liability Company/C Corporation;
 - e. Limited Liability Company/S Corporation;
 - f. Exempt;

provided, however, that if the payee is a medical/health care provider or legal services provider, then 1099 reporting may be required even though the payee is a corporation or a limited liability company with a corporate federal tax classification.

C. 1099 Reporting

- 1) **Rent** – Rent payments aggregating \$600 or more (not otherwise exempt per Paragraph II.B) are reported on Form 1099-MISC, Box 1. For 1099 reporting purposes, the term “rent” encompasses office lease payments (including real estate tax and operating costs), equipment rental, renting of meeting rooms, banquet halls and booth space; but not space in a storage facility. [See *also*, Paragraph IV, Example 11.]
 - 2) **Services** – payments aggregating \$600 or more (not otherwise exempt per Paragraph II.B) are reportable on Form 1099-MISC, Box 7 provided that such payments are for “services” provided.
- A payment is for “**services**” if labor or work effort is provided by payee. The amount to be reported on Form 1099 includes both (i) payments related to the labor or work effort and (ii) amounts paid for products, material and/or parts supplied in connection with the labor or work effort (unless such costs are separately substantiated by receipts).

Examples service-type payments for which 1099 reporting is required include:

- | | |
|---|--------------------------------------|
| ✓ Independent contractors | ✓ Advertising or other materials |
| ✓ Brokers fees (insurance; real estate) | where design services are involved |
| ✓ Consultants | ✓ Honorarium or speaker’s fee, |
| ✓ Expert Witnesses | excluding travel/lodging costs if |
| ✓ On-premises catering (with servers) | original receipts provided |
| ✓ Placement or recruiting fees | ✓ Office supplies, etc. where design |
| ✓ Repairs and maintenance | services are involved |
| ✓ Transportation costs | ✓ Retirement payments to former |
| ✓ Registration fees for seminars, CLE | partners or employees |

Example 1: Firm purchases office supplies, parts, materials from a vendor (not otherwise exempt under Paragraph II.B). No 1099 reporting is required provided no “services” are involved. (Delivery services are not considered “services” for 1099 reporting purposes. Similarly, simply customizing a product by applying the firm’s logo or printing text developed by the law firm on an invitation are not considered “services” for 1099 reporting.)

Example 2: Firm purchases ad space in a publication (not otherwise exempt from 1099 reporting under Paragraph II.B). The publication’s creative department designs and produces the ad copy. Since creative work effort is involved, the cost of the ad and the design services are reportable on Form 1099-MISC.

Example 3: In Year 1, firm hires a design firm (not otherwise exempt under Paragraph II.B) to create and print a brochure. 1,000 copies are printed by the design firm in Year 1. A 1099 should be issued to the design firm for Year 1 covering the services provided and brochures produced. In Year 2 the firm an additional 2,000 copies of the brochure are printed by the design firm. Because the subsequent work 2 does not involve additional “services,” a 1099 is not required for Year 2.

Example 4: Firm’s outside IT consultant (not otherwise exempt per Paragraph II.B) repairs or upgrades computer equipment, providing parts and software. Unless the consultant is otherwise exempt per Paragraph II.B, since labor is involved, 1099 reporting is required. The amount to be reported on Form 1099-MISC is the full amount billed, unless original receipts for the cost of the parts and software are provided. Even if the payee separately invoices the labor and parts/software, the full amount of payment must be reported on Form 1099-MISC unless original receipts for out-of-pocket costs are provided.

Example 5: Firm provides a scholarship to someone not an employee (or dependent of an employee). If no labor or other services are required in return for the scholarship, then no 1099 reporting required.

III. Medical/Health Care Service Providers.

Payments or \$600 or more made in the course of the law firm’s trade or business to medical/health care service providers for services is reportable on Form 1099-MISC, Box 6, unless the payee’s federal tax classification is “Exempt.”

- If your law firm pays a medical/health care service provider to provide services (e.g., to examine a client or evaluate/provide expert testimony), then 1099 reporting requirements apply even if the medical/health service provider is a corporation or an LLC with a corporate federal tax classification.
- Supplying copies of existing medical records (where no new services are provided) is not a “service” and no 1099 reporting is required for such payments.

IV. Legal Service Providers.

Payments to a law firm of \$600 or more must be reportable on Form 1099-MISC regardless of the payee law firm’s federal tax classification.

Example 1 – Hiring Another Law Firm: Your firm engages the ABC Law Firm to provide legal services for your firm or as local counsel for a client. Payments made by your firm to ABC Law Firm are reportable on Form 1099-MISC, Box 7.

Example 2 – Employment-related Claims: Assume your firm settles an employment claim with a former employee (FE) for \$100,000. FE is represented by the DEF Law Firm.

- The entire \$100,000 settlement payment is most likely taxable to FE and should be reported on Form W-2 with applicable income and FICA taxes withheld.
- If the net amount of the settlement (after withholding) is payable jointly to FE and to DEF Law Firm, then (i) the entire \$100,000 (gross) amount should be reported on FE's Form W-2 and (ii) the net pay amount should be reported for DEF Law Firm on Form 1099-MISC, Box 14.
- If two checks are provided, one payable to FE and another to DEF Law Firm for its fees, then (i) the full amount of both checks (\$100,000) should be reported on FE's Form W-2 and (ii) the amount paid to DEF Law Firm should be reported on Form 1099-MISC, Box 7.

Example 3 – Other Business Transactions: Assume your firm settles a business dispute with a third party (3P) for \$300,000 and 3P was represented by GHI Law Firm.

- If the full amount of the settlement is paid to 3P, then your firm must report the full amount (\$300,000) on Form 1099-MISC, Box 3 to 3P.
- If the check is written jointly to 3P and to GHI Law Firm, then your firm is required to report the \$300,000 payment both (i) on Form 1099-MISC, Box 3 to 3P, and (ii) on Form 1099-MISC, Box 14 to GHI Law Firm.
- If separate checks are written to 3P and to GHI Law Firm, then your law firm is required to report (i) amount of both checks (\$300,000) on Form 1099-MISC, Box 3 to 3P and (ii) amount paid to GHI Law Firm on Form 1099-MISC, Box 7.

Example 4 – Remittance of Settlements to Clients: Assume your firm receives a settlement check payable to your firm and to a client, and your firm remits an amount to your client minus applicable fees and expenses. No 1099 reporting is required by your law firm with respect to the remittance to the client (since such reporting is the responsibility of the party remitting the original payment).

Example 5 – Refunds: Assume your firm returns funds to a client (e.g., overpayment of an invoice; return of client trust funds). No 1099 reporting required.

Example 6 – Barter Transactions: Assume a client, a building contractor, repays your office in settlement for legal services provided. The value of the legal services provided to the client is reportable on Form 1099-MISC, Box 7.

Example 7 – Middleman Rule: Assume your firm remits payment to a third party for services provided on behalf of a client in connection with a matter – e.g., an expert witness, technical expert, researcher, investigator. Even though the third party may technically be employed by the client, if your law firm participated in the hiring, direction or supervision of the work provided by the payee, your firm is required to report said payments on Form

1099-MISC, Box 7. (This example applies to remittances both from client trust funds and for client advances from the firm's bank account.)

Example 8 – Payments to Settlement Lienholders: Assume your firm receives a settlement on behalf of a client (C) and payments must be made to various third parties who have filed liens against C's eventual settlement. If funds are remitted to another law firm with a lien against the settlement, then your firm must report the amount paid on Form 1099-MISC, Box 7. Payments to other lienholders are not subject to 1099 reporting, provided they did not provide services in connection with the underlying case.

Example 9 – Real Estate Transactions: The rules with respect to real estate transactions are very complicated. The instructions for Form 1099-S specify that the 1099 reporting obligation falls to the "person responsible for closing the transaction." In most situations, this person is the title company or mortgage lender, but if no such party is involved, then it is the responsibility of the transferee's lawyer.

Example 10 – Interest on Client Trust Funds: While interest on IOLTA funds paid by the bank to State Bar or related organizations is not subject to 1099 reporting, interest earned on other client trust accounts and credited to the party's individual account balance of \$10 or more per year must be reported on Form 1099-INT.

Example 11 – Payments on behalf of Landlord: Assume the firm's landlord is an affiliate (e.g., one of the firm's partners or a separate entity related to firm ownership) and in lieu of rent your firm pays the mortgage, insurance and real estate taxes on behalf of the landlord, then the amount of such payments should be reported on Form 1099-MISC, Box 1 provided to the landlord (unless the landlord is otherwise exempt pursuant to Paragraph II.B).

Example 12 – Family Office: If your firm (or a lawyer in your firm) pays bills for a client (e.g., from a trust account) such amounts may be required to be aggregated for 1099 reporting purposes with the firm's other payments to service providers because such trust transactions are part of the trade or business of the law firm.

V. Filing Deadlines and Procedures.

- Copy B of the Forms 1099 must be provided to the payees by Friday, January 31, 2014.
- Copy A of the Forms 1099 must be filed with the IRS by Friday, February 28, 2014; Monday, March 31, 2014 if you plan to file electronically.
- Use Form 1096 as a "cover letter" when filing the Forms 1099.
- You must file electronically if you have 250 or more Forms 1099 to report.
- Instructions for electronic filing are found in IRS Publication 1220 which is available on the IRS website, www.irs.gov.

VI. Substantial Penalties May Apply for Failure to Timely File 1099s.

VII. Additional Help is Available at www.irs.gov

- Instructions for Form 1099-MISC; 1099-INT; 1099-DIV
- General Instructions for Certain Informational Returns

VIII. Recap

Step 1 – Aggregate the amounts paid to payees from all sources – both firm bank accounts and client trust accounts (see Paragraph I.A., second bullet point).



Step 2 – Separate payments which constitute interest and dividends from everything else.

Interest payments to payees aggregating \$10 or more are reportable on Form 1099-INT.

Dividend payments to payees aggregating \$10 or more are reportable on Form 1099-DIV

AS to other payees with payments aggregating:

- less than \$600 ignore;
- \$600 or more, go to Step 3



Step 3 – As to the remaining payees, identify those who are **Exempt Payees or Exempt Payments** – no additional work required (see Paragraph II.B).

Exempt Payees

- Credit Card Merchants
- Government Entities
- Entities Classified for Federal Tax purposes as:
 - C Corporation*
 - S Corporation*
 - Trust/Estate
 - LLC/C Corporation*
 - LLC/S Corporation*
 - Exempt; provided, however, that medical/health care service providers and legal service providers are not excluded even though they may have “corporate status” (*) for Federal Tax purposes.

Exempt Payments

- Compensation reportable on Form W-2 or Schedule K-1
- Reimbursement payments substantiated by original receipts

As to the remaining payees (i.e., those not falling within the scope of Exempt Payees or not Exempt Payments in Paragraph II.B), go to Step 4.



Step 4 – 1099 reporting is required for remaining payees if the payments involve **Rent** or **Services**.

Rent payments are reported on Form 1099-MISC, Box 1. See Paragraph II.C.1 for an explanation of Rent.

Payments involving “**Services**” are reported on Form 1099-MISC. See discussion of “Services” at Paragraph II.C.2. See also special section on reporting payments to medical/health care service provider and to legal service providers at Paragraph III and IV, respectively.



Step 5 – Send Copy B of Forms 1099 to payees by Friday, January 31, 2014 and Copy A to the IRS by Friday, February 28, 2014 if filing by mail or March 31, 2014 if filing electronically. (Must file electronically if you have 250 or more Forms 1099 to report.)



Step 6 – Congratulate yourself on a job well done and forget about all this stuff until next time.