June 25, 1998

Honorable William V. Roth, Jr.
Chairman
Committee on Finance
United States Senate
104 Hart Senate Office Building
Washington, D.C. 20510

Honorable Bill Archer
Chairman
Committee on Ways and Means
United States House of Representatives
1236 Longworth House Office Building
Washington, D.C. 20515

Re: Senate Finance Committee Hearings Restructuring of the Internal Revenue Service Information Returns--Payments To Attorneys

Dear Chairman Roth and Chairman Archer:

As you are aware, the Section of Taxation of the American Bar Association is the national representative of the legal profession with regard to the tax system.

As part of the continuing efforts by the Section of Taxation of the American Bar Association ("ABA") to work with your Committee to simplify the tax laws, this letter outlines the widespread (and growing) confusion about the proper reporting and withholding on damage awards (including, specifically, awards that in part include attorneys' fees and awards that are made payable either to attorneys, or to a settlement fund, for distribution to plaintiffs). To resolve this confusion, we recommend (1) the repeal of the recently enacted rule requiring that gross proceeds information returns be sent to attorneys, (2) the adoption of gross proceeds information returns for plaintiffs, and (3) the clarification of the circumstances in which attorneys' fees awarded as damages are excludable from the income of the prevailing plaintiffs.

I. Sources of Confusion About Tax Treatment of Attorneys' Fees in Damage Awards.

A. New Code 6045(f), Requiring Information Returns to Attorneys. The current confusion about the tax and reporting treatment of damage awards arises from numerous sources, including an information reporting change enacted in August, 1997. This new information reporting provision, contained in Internal Revenue Code of 1986 ("Code") 6045(f), effective January 1, 1998, has expanded the scope of required tax information-reporting of amounts paid to attorneys, even where the payment includes damage awards that clearly are not taxable to the attorney, and even where the payments are made to an incorporated law firm.

This new provision may have been designed to ensure that plaintiffs (and attorneys) properly report and pay tax on any taxable damage awards (and attorneys' fees). However, it has created significant problems for information-reporting systems, since in certain circumstances it appears to require the payor of the damage award to send two information returns--one to the plaintiff and one to the attorney--each of which reports the total gross amount of the damage award.

Most Form 1099 reporting systems cannot be programmed, without significant customization costs, to send annual Form 1099 returns that double-count damage payments. The total amount reflected on any payor's Forms 1099 (which must be reported on the payor's annual Form 945 payroll tax return) should equal, not exceed, the total amount actually paid. If any Form 945 reflects more than the amount actually paid, this will create large deduction-tracking problems both for any payor and for the Internal Revenue Service ("Service").
An alternative reporting system (which has been proposed to the Service by some payors of damage awards) is to require that the gross proceeds damage award be reported only to the attorney(s), who in turn might be required to send information returns to the plaintiff(s). This solution is equally inappropriate. First, the attorneys are only the receiving agents for the plaintiffs, and as such should not be assigned any information-reporting responsibilities imposed upon the damage payors. It would not be appropriate, as an ethical matter, for the attorneys to agree to be appointed as the paying and reporting agents of the defendants, because the attorneys are retained exclusively by the plaintiffs. Second, even if the attorney(s) could be appointed as agent(s) for the defendant(s), then, by virtue of the fact that only Forms 1099 would be issued, such appointments would result in significant losses of FICA taxes on these damage awards, if and to the extent that any of these damage awards are characterized as "wages" paid to the plaintiffs. Under current law, any awards that are characterized as "back pay", or as any other type of "wages" subject to withholding, must be reported on Forms W-2 filed by the plaintiff's employer, and subjected to FICA taxes (half of which are owed by the actual employer) as well as to income tax withholding. Plaintiffs' attorneys cannot be responsible for filing Forms W-2 (and the related payroll tax return, Form 941) to report the "wage" portions of any damage awards because they have not been remitted the employer's half of the FICA taxes as part of a damage award. Even if plaintiffs' attorneys were to be assigned this Form W-2 filing responsibility, such a reporting system would confuse plaintiffs, employers and the IRS, especially for any plaintiff who may still be receiving other wages (or post-employment distributions) from the employer-defendant, that are covered by another Form W-2 (and Form 941) which is still filed by the employer.

B. Other Reporting Exemptions That Apply to Plaintiffs' Information Returns. The information-reporting confusion created by Code 6045(f) as to who has responsibility to perform the information reporting of damage proceeds has caused many plaintiffs never to receive any information return. Although the Service has never done so, it could eliminate this confusion by specifically identifying the defendant-payors as the parties responsible for sending such returns. Identification of the responsible filer of plaintiffs' Forms W-2 and 1099 will not, however, guarantee that these returns are ultimately filed, because there are several information-reporting exemptions contained in the current Code and the Regulations under Code 6041 that eliminate any filing requirement. First, information returns are required only if the income reported thereon is taxable to the plaintiff. A payor cannot ascertain what amount is taxable to the plaintiff (and therefore has no filing responsibility) in any of the following cases:

- the damages are payable to more than one plaintiff, and the payor does not know the amount paid to individual plaintiffs;
- part of the damages are tax-free fringe benefits (such as health care reimbursements), and the payor does not know the amount of non-tax-free damages; or
- part of the damages are attorneys' fees which are not taxable to the plaintiff(s), and the defendant-payar does not know the amount of such fees.

In addition, if the plaintiff-paye is incorporated, no information return is required.

The proper solution to these reporting exemptions is not the enactment of a requirement that an information return be sent to the attorney. Such requirement offers no assurance whatsoever that the plaintiff ultimately will report and pay tax on taxable damage awards.

C. Tax Treatment of Attorneys' Fees Awarded as Damages. Almost all damage awards include some amounts of attorneys' fees, either implicitly or by specific designation. In at least four scenarios (outlined below), these fee payments are not treated as income to the prevailing plaintiffs. First, attorneys' fees may not be treated as taxable to plaintiffs in a class action. Second, in certain states, such as Alabama, where the state laws grant attorneys equitable interests in damage proceeds, the attorneys' fees are not taxable to the plaintiffs. Third, if a lawyer drafts the client engagement letter and contingent fee arrangement to provide a basis for arguing that the attorney has an interest in the litigation, such letter might justify the plaintiff's exclusion of the fee from gross income. Fourth, if the plaintiff is currently performing services
for the defendant, and the case relates to those services, the attorneys' fees may in some cases be excluded from the plaintiff's income as a "working condition fringe."

If no reporting exclusion exists, and the plaintiff must report the attorneys' fees as income, the plaintiff's deduction (if any) can generally be claimed only as a below-the-line deduction, subject to the "two percent of AGI" floor and to potential alternative minimum tax.

II. Underreporting of Income by Attorneys Is Not a Current Tax Problem.

There is no indication in the legislative history for this new information reporting provision that it was designed to address the underreporting of income by attorneys. Instead, the legislative history focuses on the reporting exemption that applies to both plaintiffs and attorneys when a damage award is comprised of an unspecified amount of attorneys' fees. The new rule appears to have been designed to ensure that someone (perhaps the attorney) with specific information about the amount of damage payments to individual plaintiffs would take charge of sending information returns to these plaintiff-payees. However, as is explained in Section I. above, the new law appears to be reducing, not increasing, the prevalence of information returns to plaintiffs, because many defendants have simply stopped sending information returns to plaintiffs. Moreover, since the information returns that are required by Code 6045(f) are only the equivalent of "gross proceeds" returns, these returns will automatically overstate the amount of gross income that is taxable to the recipient attorneys, to the extent that they report any net damages actually payable to the plaintiffs. In general, these gross proceeds returns indicate only that damages were paid to certain attorneys, as agents for the plaintiffs, and that (perhaps) some portion of such damages was income to the attorneys. Accordingly, these new information returns are not likely to have any effect at all upon ensuring that the recipient attorneys properly report their fees as income.

III. Unnecessary Audit and Reporting Costs Triggered by New Reporting Provisions.

The revenue estimates associated with new Code 6045(f) were extremely modest. According to the Joint Committee on Taxation, the new provisions were expected to raise only $15,000,000 from 1997 to 2002 (i.e., $3,000,000 a year starting in 1999) and $31,000,000 from 1997 through 2007 (i.e., $3,000,000 a year from 1999 through 2003 and $4,000,000 a year from 2004 through 2007).

We do not know how the Joint Committee's revenue estimators arrived at these estimates. However, apart from any income pick-up realized from plaintiffs' income tax returns, we believe that the new law is likely to complicate severely the Service's attempts to audit both attorneys and plaintiffs, because of the inevitable mismatch between the amounts shown on information returns and the amounts reported on both attorneys' and plaintiffs' tax returns. In the case of attorneys' tax returns, since the new information returns are designed in most instances only to report "gross proceeds", not actual gross income retained by the attorneys, all Federal and state income tax returns will need to explain the significant difference between the gross damage proceeds reported on the information return and the actual gross income received by the attorneys.

In the case of the plaintiffs' tax returns, audit problems will arise, because (as explained above) there is no derivative requirement imposed upon attorneys (who have received "gross proceeds" returns) to send information returns to their clients (the plaintiffs). The Service's return-processors and auditors will therefore be responsible for tracking down all of the individual plaintiff-recipients of damage awards, to determine if these plaintiffs have correctly and timely reported the damages as gross income. If and to the extent that this information cannot be correctly collected through a combination of income tax and information returns, the likelihood of audits (of both attorneys and plaintiffs) will be increased.

Apart from these data-collection problems arising for the Service because of the inadequacies of the "gross proceeds" information returns, the filing of these returns alone already has created a substantial record-keeping burden for all covered payors and attorneys (including those who practice in professional corporations) who pay and receive attorneys' fee (contingent or otherwise) in the course of their trade or
business. Hundreds of thousands of new attorney fee payment transactions (including all of those with professional corporations which were not previously subject to any reporting) will now require tabulating and year-end reporting. Even large companies, with computerized accounts payable systems, will be required by the new law to reprogram their computers, to reverse the automatic suppression of any Form 1099 that occurs when the payee is incorporated. Costs also increase for recipients of the returns, particularly solo practitioners and small law firms who do not have the staff to handle additional government-mandated paperwork. Finally, if the Service is to utilize this information constructively, the Service will also incur significant costs. While information reported by insurance companies may be made on easily usable magnetic media, reporting by most small clients engaged in a trade or business will be done manually on paper. This form of reporting is very expensive for both the reporting party to prepare and, perhaps more importantly, for the Service to utilize.

In view of the modest revenue estimates from this provision, and considering the likely increase in the Service's audit costs, and the increased compliance costs shifted to payors (who will also now have an increased exposure to tax penalties for non-reporting, added tax law complexity and increased paperwork), it is, in our opinion, very doubtful that Code 6045(f) is a cost-effective approach to increase tax compliance. Indeed, we suspect that the private and public sector compliance costs may exceed the projected revenue gains.

IV. Proposed Solutions to Reporting Problems.

The American Bar Association is very concerned about this new information reporting provision, and believes that it is unlikely to increase income reporting by plaintiffs, but instead will only increase the information reporting burden for previously compliant taxpayers. We suggest a three-part correction to eliminate the problems described above, while improving the likelihood that plaintiffs pay the proper amount of income taxes on their net damage awards.

A. Repeal Code 6045(f) Retroactively. Because of its concerns about the information reporting confusions and burdens outlined above, the ABA House of Delegates has adopted the following resolution:

"RESOLVED, that the American Bar Association urges Congress to repeal Section 1021 of the Budget Reconciliation Bill (H.R. 2014, Code Sec. 6045(f) as amended by 97 Act Section 1021(a)), which, effective January 1, 1998, requires gross income tax 1099 reporting of all payments made to attorneys by a trade or business regardless of whether the attorney is the exclusive payee."

We believe that the retroactive repeal of Code 6045 is the only way to ensure that information returns will ever be filed to report the damages to plaintiffs that were paid in 1998. Without such retroactive repeal, it is likely that 1998 information returns will be sent only to attorneys and law firms, who in turn will not be specifically required to send any information returns to the plaintiffs, for all of the reasons outlined above. Accordingly, if Code 6045(f) is not retroactively repealed, we doubt that there will be any significant positive impact on tax compliance from this discriminatory provision. (The Joint Committee on Taxation may even share our concern, given its extremely modest revenue estimates associated with the 1997 law.)

One additional potential administrative cost-saving benefit arising from repeal of Code 6045(f) is that the Service has likely not yet started to reprogram its computers to address the processing of "gross proceeds" information returns to attorneys. Without these programming changes (which will be very expensive), there will probably be thousands of computerized audit letters sent, and unnecessary audits commenced, when, in mid-1999, there is a mismatch between the income reported on the Forms 1099-MISC and the gross income reflected on law firms' income tax returns. The repeal of Code 6045(f) will eliminate any need for the Service to undertake this reprogramming task, and will thus permit the Service to continue to devote its scarce computer programming resources to much more important projects, such as the Year 2000 reprogramming project, or to other service improvements of far more importance to taxpayers generally.
It should also be understood that the repeal of Code 6045(f) will simply reinstate the pre-1998 Code 6041(a) information reporting requirements governing payments of attorneys' fees. Under those rules, any payments of attorneys' fees of $600 or more for the taxable year made in the course of a trade or business to attorneys (other than incorporated law firms) were required to be reported on Form 1099-MISC, Box 7. Under these prior law rules (which apply generally to all Form 1099 information returns), reporting exemptions applied only in three cases. These are: (1) if the payments were made outside the course of a payor's trade or business (e.g., by an individual who hires an attorney on personal matters), (2) if the attorneys' fee income could not be distinguished from the plaintiffs' net damage awards, or from tax-exempt expense reimbursements, or (3) if the attorney recipients were incorporated. If Code 6045(f) is retroactively repealed, attorneys' fees will once again be treated for information-reporting purposes like fees paid to any other professional service-providers.

B. Require "Gross Proceeds" Returns to Be Sent Only to Plaintiffs. If Congress truly believes that information returns must be filed, in order to alert the Service to the fact that taxable damages have been paid to particular plaintiffs, the ABA urges that such returns should be sent directly (and only) to plaintiffs. Congress might also clarify the information-reporting rules by requiring that damage awards (other than amounts reportable on Forms W-2) are subject to the same "gross proceeds" reporting requirements that were contemplated when Code 6045(f) was enacted. In class actions, or other cases involving numerous plaintiffs, the party responsible for distributing the awards to the plaintiffs should be required to inform the defendant (or its agent) as to the subdivision of the damage proceeds among the plaintiffs.

Under such a gross proceeds reporting system, even if a payor does not know the precise amount of damage proceeds that should be treated as taxable income to individual plaintiffs, it could, at a minimum, file an information return with the Service, to alert the Service to the fact that the damages were paid to a particular listed class of plaintiffs. Very importantly, the party responsible for sending these returns should in all cases be the defendant payors (or their agents), and not the attorneys for the plaintiffs.

C. Clarify the Exemption from Plaintiffs' Income of Attorneys' Fees Awards. Any information reporting of gross damage proceeds to plaintiffs will inevitably raise questions for both taxpayers and the Service's return-processors about the types of attorneys' fees included in gross damage proceeds that should be excluded from the plaintiffs' incomes. There is considerable dispute among taxpayer-plaintiffs, however, about the operation of income exclusions for attorneys' fees--i.e., when such fees should, under current law, be treated as taxable income to the plaintiff(s). Plaintiffs who fail to qualify for any of these existing exclusions are potentially subject to large alternative minimum tax bills (like those faced by the unfortunate plaintiff in Alexander v. Commissioner). They are therefore likely to interpret aggressively the income inclusions applicable to attorneys' fees which are included in "gross proceeds". To minimize future controversies on audit of plaintiffs' income tax returns, Congress should clarify (in the legislative history of the revised reporting rules applicable to damage awards or otherwise) the precise types of attorneys' fees that are part of damage awards which are excludable from gross income (including class-action attorneys' fees, pure contingent fees, and "working condition fringes").

We appreciate your willingness to allow us to submit this statement, as a supplement to the testimony previously submitted to your Committee by the Section of Taxation of the ABA, on proposals to improve and simplify the tax laws. We would be pleased to meet with you, other members of the Senate Finance Committee or your staff to discuss this matter further.

Sincerely yours,

Stefan F. Tucker

cc: Honorable Charles B. Rangel, Ranking Democratic Member, Committee on Ways and Means
Honorable Daniel P. Moynihan, Ranking Democratic Member, Committee on Finance
Honorable Donald C. Lubick, Assistant Secretary, (Tax Policy), Department of the Treasury