Proposed IRS Regulations Raise Ethical Concerns

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Politicians hailed the Taxpayer Relief Act of 1997Ftn 1 as a revolution for the rights of taxpayers. Lawyers may feel left out of the revolution when they begin complying with the Act's new reporting requirements, for which the Internal Revenue Service has recently promulgated proposed implementing rules.Ftn 2 Although the Director will leave most of the implications of this law to tax lawyers and accountants, the new regulations do raise some ethical issues, of which attorneys should be aware.

Pursuant to the Act and the proposed rules, beginning January 1, 2000, anyone who, in the course of a trade or business, makes a payment of "gross proceeds" to an attorney in connection with legal services must prepare an information return on Form 1099-MISC. The rule applies regardless of whether the legal services were performed for the payor of the funds. No amount is too small to escape the reporting requirement. Replace "gross proceeds" with "settlement funds" and one can see the impact of this new rule: settlement payments from most defending parties to an attorney must be accompanied by a Form 1099. The law will have the most impact on parties that settle multiple lawsuits, such as insurance companies, and on attorneys, who must also complete 1099s when making payments to other lawyers and who also may have to provide separate explanations on their tax returns for the difference between each gross 1099 and the portion they received as attorney fees and costs.

Confidentiality (Rule 1.6). The IRS provides several examples in the proposed regulation to illustrate its effects. One explains that an insurer settling a lawsuit for $300,000 must file a Form 1099 for that amount on the plaintiff's lawyer. If the insurer is aware, however, that the attorney's fee in the case is only $100,000, then the insurer need only complete the 1099 on that attorney for the amount of the fees. This suggests that settling defendants will ask for breakdowns of how much an attorney's fee is. From an attorney's administrative perspective, it might also be advantageous to only receive 1099s for the amount of his or her fee.

An attorney's fee arrangement with a client typically constitutes a protected confidence within the meaning of Rule 1.6(d), Minnesota Rules of Professional Conduct (MRPC). The rule prohibits a lawyer from revealing that information without the client's consent, unless the lawyer is attempting to establish or collect her own fee or a law or court order overrides the confidentiality rule.Ftn 3 The new IRS regulation does not specifically instruct a lawyer to reveal her fee, so she may not do so without her client's consent. In some negotiations, it may be advantageous for a lawyer to reveal her fee; lawyers must consider each case separately.

Theoretically, a lawyer who receives a 1099 for the gross proceeds of a settlement may be forced to state their fee percentage when completing their tax returns so that tax is only paid on the income received by the lawyer. In this situation, Rule 1.6(b)(2) and (b)(5) both arguably allow the lawyer to disclose the amount of her fee on her tax return. The strict privacy laws governing tax returns and other information submitted to the IRS effectively eliminate any risk of inadvertent disclosure.

Fee Splitting (Rule 1.5(e)). Minnesota lawyers may split fees with a referring attorney as long as the fee is reasonable, the client consents to the division, and the fees are either in proportion to the services performed by each lawyer or each lawyer has assumed responsibility in writing for the representation. *See* Rule 1.5(e), MRPC. Another of the IRS' specific examples demonstrates that the new regulation attaches a tax reporting obligation on lawyers who make payments to other attorneys in connection with legal services. This is not a new requirement but a reinforcement of existing tax laws.

This reporting scheme has other beneficial effects besides encouraging lawyers to pay taxes on all income received. Such documentation encourages lawyers to communicate with each other and with client regarding fee-splitting arrangements. It also reinforces lawyers' awareness and compliance with the provisions of Rule 1.5(e).

Trust Account Records (Rule 1.15 and LPRB Opinion 9). Lawyers are already required to maintain detailed checkbook registers and subsidiary ledgers and are instructed to clearly annotate trust account checks. Nevertheless, some lawyers fail to maintain those records, rationalizing that "I only practice personal injury law and the settlements just go right into my trust account and then out again, so there's nothing to keep track of." There have been several cases in which this faulty logic has led to discipline. For those remain reluctant to maintain proper records, the IRS provides a new motivation; lawyers who receive 1099s for settlement proceeds will want to demonstrate that they did not receive the entire settlement as income. Properly maintained trust account books and records should provide sufficient information to meet his burden.

The new reporting requirement may become nothing more than an administrative burden without any substantive impact on lawyers' practices. Like the dreaded year 2000 problem, the full impact may not be known until lawyers return to work after New Years Day. Some lawyers may hope that the Y2K bug will shut down the computers that generate new IRS regulations. The safer route is to take heed of the new regulations and their ethical implications.

Footnotes:

1 Public law 105-34, 11 Stat. 922.

2 Reporting of Gross Proceeds Payments to Attorneys, 64 Fed. Reg. 27730 (May 21, 1999) (to be codified at 26 CFR § 1.6045-5.

3 *See* Rule 1.6(b)(2) and 1.6(b)(5), MRPC.