

Notice of Proposed Rulemaking and Notice of Public Hearing

Reporting of Gross Proceeds Payments to Attorneys

REG-126024-01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the reporting of payments of gross proceeds to attorneys. The regulations reflect changes to the law made by the Taxpayer Relief Act of 1997 (1997 Act). The regulations will affect attorneys who receive payments of gross proceeds on behalf of their clients and certain payors (for example, defendants in lawsuits and their insurance companies and agents) that, in the course of their trades or businesses, make payments to these attorneys. This

document also provides notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by August 15, 2002. Requests to speak (with outlines of topics to be discussed) at the public hearing scheduled for September 30, 2002, at 10 a.m., must be received by September 9, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG-126024-01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG-126024-01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically by submitting comments directly to the IRS Internet site at www.irs.gov/regs. The public hearing will be held in the Auditorium on the Seventh Floor of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Nancy Rose (202) 622-4910; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Treena Garrett at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1644.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number assigned by the **Office of Management and Budget**.

Books or records relating to a collection of information must be retained as

long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 6041 and 6045 of the Internal Revenue Code (Code). These proposed amendments to the Income Tax Regulations would (a) revise existing §§ 1.6041-1 and 1.6041-3 and (b) add a new § 1.6045-5.

A new reporting requirement, section 6045(f), was added to the Code by section 1021 of the Taxpayer Relief Act of 1997 (1997-4 (Vol. 1) C.B. 1, 136). Section 6045(f) generally requires information reporting for payments of gross proceeds made in the course of a trade or business to attorneys in connection with legal services (whether or not the services are performed for the payor). No information return is required under section 6045(f) for the portion of any payment that is required to be reported under section 6041(a) (or that would be required to be reported under section 6041 but for the \$600 limitation) or under section 6051. The 1997 Act also provides that the general exception in § 1.6041-3(q)(1) for reporting payments made to corporations does not apply to payments of attorneys' fees.

Proposed regulations under sections 6041 and 6045(f) were previously published in the **Federal Register** on May 21, 1999 (REG-105312-98, 1999-1 C.B. 1193 [64 FR 27730]) (the 1999 proposed regulations). Many individuals and organizations provided written comments on the 1999 proposed regulations. Several individuals spoke at a public hearing held on September 22, 1999.

After considering all of the comments, the IRS and the Treasury Department have decided to amend and repropose the regulations under sections 6041 and 6045(f), incorporating the guidance in the 1999 proposed regulations with some modifications. All comments received in connection with the 1999 proposed regulations will continue to be considered in

finalizing these repropounded regulations (the proposed regulations). The IRS and the Treasury Department welcome any additional comments from taxpayers on the issues discussed below or on other issues relating to section 6045(f).

Explanation of Revisions

Delivery Rule

Section 1.6045-5(b)(1) of the 1999 proposed regulations (the delivery rule) elicited numerous comments. The delivery rule required information reporting of payments delivered to a nonpayee attorney, if under the circumstances, it was reasonable for the payor to believe that the attorney received the check in connection with legal services. Most of the comments urged the IRS and the Treasury Department to eliminate the delivery rule for a variety of reasons.

First, commentators suggested that the benefits the IRS would derive from receiving information regarding payments of gross proceeds to nonpayee attorneys would be outweighed by the burdens payors would encounter in collecting and reporting that information. Several commentators stated that their automated information collection and processing systems cannot prepare returns for nonpayee recipients. Consequently, they would incur substantial costs to accommodate reporting to nonpayee attorneys, either by modifying those systems or by manually preparing information returns for nonpayee attorneys.

Second, commentators stated that the delivery rule creates the potential for unintentional noncompliance because the department of a payor's business that delivers checks to nonpayee attorneys is separate from, and may be in a different location from, the department that prepares the information returns. Due to this business structure, the reporting department may not receive the required information from the delivery department.

Other commentators stated that the delivery rule unnecessarily complicates the requirement to backup withhold on payments made to an attorney who does not provide a taxpayer identification number (TIN). Many commentators also argued that delivering a check to a nonpayee does not constitute "making a payment" to that person under section

6045(f) or other information reporting provisions of the Code.

Due to the substantial burdens that the delivery rule would impose on payors, the IRS and the Treasury Department have adopted the suggestion to eliminate it. Thus, the proposed regulations provide that a payment to an attorney, in the case of a payment by check, means a check on which the attorney is named as a sole, joint, or alternative payee.

Identity of the Payor

Several commentators suggested that the proposed regulations define the term "payor" under section 6045(f). Specifically, these commentators suggested that the section 6041(a) payor standard should also be used under section 6045(f), principally for three reasons. First, the language in both Code sections regarding who is required to report is virtually identical, that is, a person engaged in a trade or business and making payments in the course of that trade or business. Second, using different standards could lead to confusion. Third, commentators from the banking and mortgage lending industry were concerned that they would incur substantial costs of reporting payments made to lawyer-owned title insurance companies and settlement attorneys unless the regulations under section 6045(f) adopted the section 6041(a) payor standard.

The IRS and the Treasury Department agree that defining the term payor would be helpful. The proposed regulations define a payor as a person who makes a payment if that person is an obligor on the payment, or the obligor's insurer or guarantor. For example, a payor includes (a) a person who pays a settlement amount to an attorney of a client who has asserted a tort, contract, violation of law, or workers' compensation claim against that person; and (b) the person's insurer if the insurer pays the settlement amount to the attorney.

The IRS and the Treasury Department believe that the payor standards under sections 6041 and 6045(f) should not be identical because the nature and the purpose of the reporting requirements under each Code section are different. The legislative history of the 1997 Act, describing the law regarding information reporting of payments to attorneys before

enactment of section 6045(f), states that if "the payment [to the attorney] is a gross amount and it is not known what portion is the attorney's fee, no reporting is required on any portion of the payment." H.R. Rep. No. 148, 105th Cong., 1st Sess. 474 (1997). The Committee Report then states that section 6045(f) "will have a positive impact on compliance with the tax laws by requiring additional information reporting." H.R. Rep. No. 148, at 474 (1997). A specific concern was that there was no reporting by payors (and underreporting by recipients) of payments of judgments and settlements made by insurance companies to attorneys that yielded large legal fees. See Department of the Treasury, *General Explanations of the Administration's Revenue Proposals* 86 (February 1997).

The additional reporting that Congress contemplated, and about which the Treasury Department was concerned, will not occur if the section 6041 payor standard is used under section 6045(f). Generally under section 6041, a person who makes a payment on behalf of a third person reports the payment only if the first person exercises management or oversight in connection with, or has a significant economic interest in, the payment. See Rev. Rul. 93-70, 1993-2 C.B. 294. Under the proposed section 6041 middleman regulations published in the **Federal Register** on October 17, 2000 (65 FR 61292), a defendant or its insurer that pays tort damages to a claimant's attorney generally does not exercise management or oversight in connection with, or have a significant economic interest in, the payment to the attorney. The preamble to those proposed regulations explains that neither the defendant nor the insurer is required to file an information return under section 6041(a) for the payment made to the attorney. 65 FR 61293-61294. If the section 6041 middleman rules were used under section 6045(f), the defendant and the insurer would not be required to report the payments to the attorney under section 6045(f) either. The large payments by insurers to attorneys in judgments and settlements would go unreported by any payor, as was the case prior to the enactment of section 6045(f). The IRS and the Treasury Department believe that Congress did not intend this result. Thus, the suggestion to use the

section 6041 payor standard for section 6045(f) has not been adopted.

Scope of the Section 6045(f)(2)(B) Exception

Section 6045(f)(2)(B) states that section 6045(f) “shall not apply to the portion of any payment that is required to be reported under section 6041(a) (or would be so required but for the \$600 limitation contained therein) or section 6051.” The use of different standards under sections 6041 and 6045(f) for determining who is required to file and furnish an information return affects the scope of the exception to reporting in section 6045(f)(2)(B). For example, assume that a defendant’s insurer, to settle a claimant’s lawsuit for taxable damages, wrote a check for \$100,000 jointly to the claimant and the claimant’s attorney and that the insurer knew that the attorney’s fees were \$40,000. Under section 6045(f), the insurer is required to report the \$100,000 payment to the attorney. The exception in section 6045(f)(2)(B) does not apply because the insurer has no information reporting obligation under section 6041 with respect to the payment to the attorney.

Some commentators suggested a very broad reading of the exception to reporting contained in section 6045(f)(2)(B). Under the approach suggested by these commentators, this exception would apply if the payment to the attorney is subject to reporting under section 6041 or section 6051 by any person. For example, under this view, if a claimant in a lawsuit is required to report under section 6041 the portion of a damage award that his attorney retained as a contingent fee, then the defendant’s insurance company, which paid those damages to the claimant’s attorney, would not report the payment under section 6045(f). The IRS and the Treasury Department believe, however, that Congress intended the exception in section 6045(f)(2)(B) to provide relief only to the person who is required (or would be so required but for the dollar limitation) to report the payment to the attorney under section 6041 or section 6051. First, a payor is best able to determine whether it is required to report a payment based on its relationship to the payment rather than that of an unrelated (and possibly adversarial) third party.

Second, requiring a payor to determine whether a third party is required to report a payment could introduce inconsistency into the reporting process if the payor and the third party disagree on whether the third party is required to report a payment under section 6041 or section 6051.

On a related matter, one commentator noted that some practitioners believe that if a payment (or portion of a payment) is reportable under section 6045(f), then under § 1.6041-1(a)(1)(ii) it is not subject to reporting under section 6041 with respect to another payee. This view contradicts Congress’ purpose in enacting section 6045(f), which is to “have a positive impact on compliance with tax laws by requiring additional information reporting.” H.R. Rep. No. 148, at 474 (1997). Therefore, § 1.6041-1(a)(1)(ii) has been clarified to provide explicitly that the exception applies to a payment with respect to which information returns are required under section 6041(a) and another Code section (e.g., section 6045) for the same payee. For example, a person who pays \$600 of taxable damages to a claimant and the claimant’s attorney may be required to file an information return under section 6041 with respect to the claimant and another information return under section 6045(f) with respect to the claimant’s attorney.

De Minimis Payments

Many commentators suggested that the statutory \$600 annual threshold for reporting payments under section 6041 should also apply under section 6045(f). Many payors who are required to report payments under section 6045(f) also are required to report payments under section 6041. In many cases, payments under both Code sections are reported on Forms 1099-MISC. Commentators stressed that payors would incur substantial costs to report payments that aggregated less than \$600 annually, because they would have to either modify their automated processing systems or manually prepare returns reporting these payments. They argued that this burden far outweighs any benefit to be derived from collecting information for the relatively few payments made to attorneys that do not aggregate at least \$600 during a calendar year. In light of these circumstances, the proposed regulations adopt a \$600 annual reporting

threshold because such a threshold strikes a reasonable balance between the objectives of section 6045(f) and the potential burden of compliance.

Form 1099-MISC and Payee Statement

Most commentators approved of using Form 1099-MISC to report payments under section 6045(f) because their existing automated information processing systems are programmed to complete this form. However, a few commentators suggested that, because Form 1099-MISC is used to report income payments, it should not be used to report payments of gross proceeds. Some of these commentators also noted that some payors had improperly reported gross proceeds payments in an income box on Form 1099-MISC.

Beginning in 2001, the Form 1099-MISC was revised to add a separate and distinctly labeled box for reporting gross proceeds payments made to attorneys. Therefore, payments under section 6045(f) will continue to be reported on Form 1099-MISC. However, so that the IRS can easily change to another form if the need arises, the proposed regulations do not specify the form to be used.

Separate or Aggregate Reporting

Some commentators believed that, for each reportable payment under section 6045(f), payors should be required to file and furnish a separate Form 1099 listing the name of the attorney’s client. These commentators were concerned that attorneys would have difficulty reconciling payee statements containing aggregate annual payments with their other records, an exercise that might be necessary if their income tax returns were examined by the IRS. However, other commentators asserted that requiring such detailed payee statements would impose an enormous burden on payors. These commentators urged that providing such detailed information should be voluntary, and noted that many payors provide such information to payees upon request. On balance, the IRS and the Treasury Department believe that the potential burden on payors that would result if separate payee statements were made mandatory outweighs the potential benefit of such statements to payees. Accordingly, under the proposed regulations, payors may file

either one Form 1099–MISC that aggregates annual payments or separate Forms 1099–MISC for each payment. However, further comments on this question are welcome.

Joint or Multiple Payees

Section 1.6045–5(b)(2)(i) of the 1999 proposed regulations provided that if more than one attorney is listed as a payee on a check, the information return is required to be filed with respect to the attorney who received the check (the payee-recipient rule). For some of the same reasons that the delivery rule was criticized, several commentators suggested that if more than one attorney's name is listed on a check, the payor should be required to issue an information return with respect to the first-listed attorney (the first-listed rule). In addition, one commentator suggested that where joint or multiple payees are listed on a check, the payor should be required to report with respect to each attorney listed as a payee on the check (the all-payee rule).

The IRS and the Treasury Department carefully considered whether the payee-recipient rule raises the same problems as the delivery rule and believe that it does not. Commentators' principal objection to the delivery rule was that their automated information reporting systems are designed to capture information about check payees, not mere addressees or deliverers. The payee-recipient rule, however, requires that the recipient of the check also be named as a payee and thus does not raise the same concerns as the delivery rule. The IRS and the Treasury Department considered and rejected the first-listed payee rule because it would result in no information reporting with respect to an attorney who receives the check and is not the first-listed payee attorney. Finally, the IRS and the Treasury Department considered and rejected the all-payee rule because, as between the two, the payee-recipient rule appears to be less burdensome for most payors. Therefore, the proposed regulations retain the payee-recipient rule. The IRS and the Treasury Department, however, request comments on the effectiveness of, and the

relative burdens imposed by, each of these three approaches.

Exceptions for Certain Types of Payments

Many commentators suggested that the definition of the term legal services in § 1.6045–5(d)(2) of the 1999 proposed regulations was too broad. These commentators requested an exception to the section 6045(f) information reporting requirement in certain circumstances where they believed the specific payment bears little or no correlation to the taxable income of the attorney or the attorney's client. Specifically, they suggested exceptions to reporting for payments to payee attorneys who were acting as (i) settlement attorneys or title insurers in real estate transactions, (ii) executors or administrators of estates (for example, those receiving payments of life insurance proceeds), (iii) trustees of trusts (such as pension plans and bankruptcy estates), and (iv) administrators of qualified settlement funds described in § 1.468B–1.

Consistent with the language and purpose of section 6045(f), the IRS and the Treasury Department continue to believe that a broad definition of legal services is appropriate. However, it should be noted that other features of the proposed regulations, such as the elimination of the delivery rule, may provide a result equivalent to an exception in many cases. For example, the IRS and the Treasury Department understand that it is unusual for an attorney who is the executor or administrator of an estate to be named as the payee on a check. Similarly, in many bankruptcy situations the estate of the bankrupt, rather than the trustee, is the named payee. Further, under these proposed regulations, many payors will be able to avoid reporting under section 6045(f) simply by naming the attorney's client as payee on the check even if the check is delivered to the attorney's office. Finally, the proposed regulations provide that payments made to an attorney acting in the capacity as a settlement agent in connection with the closing of a real estate transaction are not subject to

reporting under section 6045(f). The IRS and the Treasury Department believe that the flexibility provided by these rules should reduce the need for many of the requested exceptions from the term legal services. However, comments on additional exceptions where such flexibility is not practical are welcome.

The proposed regulations also provide a clearer and more objective standard for determining whether a payment made to a foreign attorney is subject to reporting under section 6045(f). Under the proposed regulations, a return of information is not required under section 6045(f) with respect to payments made to a nonresident alien individual, foreign partnership, or foreign corporation that does not engage in a trade or business in the United States and does not perform any labor or personal services in the United States. The proposed regulations provide that the rules provided in § 1.6041–4(a)(1) are used to determine whether a payment is subject to this exception. Thus, the payor makes this determination by obtaining from the payee a Form W–8, a Form W–9, or other documentation conforming in substance to those forms, or by relying on the presumptions provided under § 1.1441–1(b)(3).

Other commentators asked for exceptions for situations in which attorneys who, after collecting their fees for legal services rendered, continue to serve as mere clearinghouses or delivery conduits to their clients. For example, attorneys sometimes collect and disburse payments intact for: (1) a transient or homeless client; (2) a client whose address is intentionally not disclosed to the payee; or (3) a client who is entitled to recurring payments in satisfaction of the client's workers' compensation claim. In addition, sometimes a payor is required to make payments to third-party service providers through an attorney to monitor payor compliance, even though the attorney does not charge a separate fee for this service. The IRS and the Treasury Department have not adopted this suggested exception to the section 6045(f) reporting requirement, because it is too

burdensome to require a payor to determine whether any portion of a specific payment is being retained by the attorney as a fee.

Therefore, the proposed regulations adopt, with a minor clarification, the definition of the term legal services used in the 1999 proposed regulations. Under the proposed regulations, the term legal services means all services related to, or supportive of, the practice of law performed by, or under the supervision of, an attorney. Including services that are related to, or supportive of, the practice of law in the definition of legal services continues the broad definition in the 1999 proposed regulations. It also clarifies that payments to an attorney for services that are clearly unrelated to the practice of law are not subject to reporting under section 6045(f). For example, a payment to an individual for refurbishing an antique automobile is not subject to reporting under section 6045(f) merely because that individual is a tax lawyer.

Backup Withholding

Some commentators suggested either eliminating the requirement for a payor to backup withhold on a payment made to an attorney who does not furnish a TIN or, if such withholding is required, permitting the withheld amounts to be credited to the account of the attorney's client. The IRS and the Treasury Department believe that payments to attorneys for legal services are reportable payments under section 3406(b)(3)(C), and thus are subject to the backup withholding requirements. Further, the following statement in the legislative history of section 6045(f) shows that Congress specifically intended payments to attorneys that are reportable under section 6045(f) to be subject to backup withholding:

Third, attorneys are required to promptly supply their TINs to persons required to file these information reports, pursuant to section 6109. Failure to do so could result in the attorney being subject to penalty under section 6723 and the payments being subject to backup withholding under section 3406.

H.R. Conf. Rep. No. 220, at 546 (1997). Accordingly, this suggestion has not been adopted in the proposed regulations. However, eliminating the delivery

rule may alleviate many concerns regarding backup withholding on payments to attorneys who do not supply their TINs.

Revision of Examples

Several comments were received regarding the examples in § 1.6045-5(f) of the 1999 proposed regulations. Commentators suggested that *Example 1* be revised to clarify that the defendant in the lawsuit was the claimant's employer and that the amount disbursed by the defendant to the claimant's attorneys should be reduced to reflect payments of income and Federal Insurance Contributions Act tax withholdings. These revisions have been adopted.

Some commentators expressed concern that the examples imply that all damages in a lawsuit against an employer are back wages reportable under Forms W-2. *Example 1* has been clarified to explain that, under its particular facts, the damages received are taxable wages under existing legal principles. Further, the examples are not intended to state or imply any substantive conclusion on the tax treatment of any particular type of damage award.

Some commentators stated that the examples did not provide sufficient guidance on the reporting of damages under sections 6041 and 6051. The IRS and the Treasury Department understand taxpayers' interest in additional guidance in this area, due in part to significant changes in the law under section 104(a)(2). However, regulations under section 6045(f) are not the appropriate place to address legal issues involving concerns under sections 6041 and 6051. Thus, these proposed regulations address issues under sections 6041 and 6051 only to the extent they are integral or closely related to providing guidance regarding section 6045(f).

Finally, in response to numerous requests, the 1999 proposed regulations have been expanded to provide additional examples of required reporting.

Amendment to § 1.6041-3(q)

Section 1.6041-3(q) of the 1999 proposed regulations provided that payments to a corporation engaged in providing legal services did not qualify for the exception for reporting payments to cor-

porations. These proposed regulations conform the language of section 1.6041-3(q) to that of section 1021(b) of the 1997 Act by providing that payments of attorneys' fees made to a corporation do not qualify for the exception for reporting payments to corporations under section 6041.

Effective Date of Proposed Regulations under Section 6045(f)

In response to several comments received concerning the amount of time needed to implement automated processing systems changes, the effective date of the regulations has been delayed. The regulations will apply to payments made during the first calendar year that begins at least two months after the date of publication of the final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. Chapter 5) does not apply to these regulations.

It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the facts that: (1) the time required to prepare and file a 2002 Form 1099-MISC is minimal (currently estimated at 16 minutes per form); and (2) it is not anticipated that, as a result of these regulations, small entities will have to prepare and file more than a few, at most, forms per year. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration

will be given to any written comments (a signed original and eight (8) copies) that are submitted timely (in the manner described in the **ADDRESSES** portion of this preamble) to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. Written comments on the proposed regulations are due by August 15, 2002.

A public hearing has been scheduled for September 30, 2002, beginning at 10 a.m. in the Auditorium on the Seventh Floor of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by September 9, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for reviewing outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is A. Katharine Jacob Kiss, Office of Associate Chief Counsel (Income Tax and Accounting). However,

other personnel from the IRS and the Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Par. 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In § 1.6041-1(a)(1)(ii), the first sentence is removed and three sentences are added in its place to read as follows:

§ 1.6041-1 Return of information as to payments of \$600 or more.

(a) * * *

(1) * * *

(ii) The payments described in paragraphs (a)(1)(i)(A) and (B) of this section shall not include any payments of amounts with respect to which an information return is required by, or may be required under authority of, section 6042(a) (relating to dividends), section 6043(a)(2) (relating to distributions in liquidation), section 6044(a) (relating to patronage dividends), section 6045 (relating to brokers' transactions with customers), sections 6049(a)(1) and (2) (relating to interest), section 6050N(a) (relating to royalties), or section 6050P(a) or (b) (relating to cancellation of indebtedness) with respect to the same payee. For example, a person who pays \$600 of taxable damages to a claimant and the claimant's attorney may be required to file an information return under section 6041 with respect to the claimant and another information return under section 6045(f) with respect to the claimant's attorney. In addition, notwithstanding anything in the preceding two sentences, payments to an attorney that are described in paragraph

(a)(1)(i) of this section are reported under this section and not section 6045(f). For provisions relating to information reporting on payments to attorneys, see § 1.6045-5. * * *

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Par. 3. Section 1.6041-3 is amended by revising the first sentence of paragraph (q)(1) to read as follows:

§ 1.6041-3 Payments for which no return of information is required under section 6041.

* * * * *

(q) * * *

(1) A corporation described in § 1.6049-4(c)(1)(ii)(A), except to a corporation for payments of attorneys' fees made after December 31, 1997, and except to a corporation engaged in providing medical and health care services or engaged in the billing and collecting of payments in respect to the providing of medical and health care services. * * *

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Par. 4. Section 1.6045-5 is added to read as follows:

§ 1.6045-5 Information reporting on payments to attorneys.

(a) *Requirement of reporting—(1) In general.* Except as provided in paragraph (c) of this section, every payor engaged in a trade or business who, in the course of that trade or business, makes payments aggregating \$600 or more during a calendar year to an attorney in connection with legal services (whether or not the services are performed for the payor) must file an information return for such payments. The information return must be filed on the form and in the manner required by the Commissioner. For the time and place of filing the form, see § 1.6041-6. For definitions of the terms under this section, see paragraph (d) of this section. The

requirements of this paragraph (a)(1) apply whether or not—

(i) A portion of a payment is kept by the attorney as compensation for legal services rendered; or

(ii) Other information returns are required with respect to some or all of a payment under other provisions of the Internal Revenue Code and the regulations thereunder.

(2) *Information required.* The information return required under paragraph (a)(1) of this section must include the following information—

(i) The name, address, and taxpayer identification number (TIN) (as defined in section 7701(a)) of the payor;

(ii) The name, address, and TIN of the payee attorney;

(iii) The amount of the payment or payments (as defined in paragraph (d)(5) of this section); and

(iv) Any other information required by the Commissioner.

(3) *Requirement to furnish statement.* A person required to file an information return under paragraph (a)(1) of this section must furnish to the attorney a written statement of the information required to be shown on the return. This requirement may be met by furnishing a copy of the return to the attorney. The written statement must be furnished to the attorney on or before January 31 of the year following the calendar year in which the payment was made.

(b) *Special rules—(1) Joint or multiple payees—(i) Check delivered to payee attorney.* If more than one attorney is listed as a payee on a check, an information return must be filed under paragraph (a)(1) of this section with respect to the payee attorney, if any, who received the check.

(ii) *Check delivered to nonpayee or to payee nonattorney.* If one or more than one attorney is listed as a payee on a check and the check is delivered to a person who is not a payee on the check, or to a payee who is not an attorney, an information return must be filed under paragraph (a)(1) of this section with respect to the first-listed payee attorney on the check.

(2) *Attorney required to report payments made to other attorneys.* If, due to the payment of a check, an information return is required to be filed under para-

graph (b)(1) of this section, the attorney with respect to whom the information return is required to be filed (tier-one attorney) must file an information return, as required under this section, for any payment that the tier-one attorney makes to other attorneys with respect to that check, regardless of whether the tier-one attorney is a payor under paragraph (d)(3) of this section.

(c) *Exceptions.* Notwithstanding paragraphs (a) and (b) of this section, a return of information is not required under section 6045(f) with respect to the following payments—

(1) Payments of wages or other compensation paid to an attorney by the attorney's employer.

(2) Payments of compensation or profits paid or distributed to its partners by a partnership engaged in providing legal services.

(3) Payments of dividends or corporate earnings and profits paid to its shareholders by a corporation engaged in providing legal services.

(4) Payments made by a person to the extent that the person is required to report with respect to the same payee the payments or portions thereof under section 6041(a) and § 1.6041-1(a) (or would be required to so report the payments or portions thereof but for the dollar amount limitation contained in section 6041(a) and § 1.6041-1(a)).

(5) Payments made to a nonresident alien individual, foreign partnership, or foreign corporation that does not engage in a trade or business in the United States and does not perform any labor or personal services in the United States. For how a payor determines whether a payment is subject to this exception, see § 1.6041-4(a)(1).

(6) Payments made to an attorney in the attorney's capacity as the person responsible for closing a transaction within the meaning of § 1.6045-4(e)(3) for the sale or exchange of any present or future ownership interest in real estate described in § 1.6045-4(b)(2)(i) through (iv).

(d) *Definitions.* The following definitions apply for purposes of this section:

(1) *Attorney* means a person engaged in the practice of law, whether as a sole proprietor, partnership, corporation, or joint venture.

(2) *Legal services* means all services related to, or supportive of, the practice of law performed by, or under the supervision of, an attorney.

(3) *Payor* means a person who makes a payment if that person is an obligor on the payment, or the obligor's insurer or guarantor. For example, a payor includes a person who pays a settlement amount to an attorney of a client who has asserted a tort, contract, violation of law, or workers' compensation claim against that person and the person's insurer if the insurer pays the settlement amount to the attorney.

(4) *Payments to an attorney* in the case of a payment by check means a check on which the attorney is named as a sole, joint, or alternative payee.

(5) *Amount of the payment* in the case of a check means the amount of the check plus the amount required to be withheld from the payment under section 3406(a)(1), because a condition for withholding exists with respect to the attorney for whom an information return is required to be filed under paragraph (a)(1) of this section.

(e) *Attorney to furnish TIN.* A payor that is required to file an information return under this section must solicit a TIN from the attorney at or before the time the payor makes a payment to the attorney. Any attorney must furnish the TIN to the payor, but is not required to certify that the TIN is correct. See, however, paragraph (c)(5) of this section regarding payments to certain foreign attorneys. A payment for which a return of information is required under this section is subject to backup withholding under section 3406 and the regulations thereunder.

(f) *Examples.* The provisions of this section are illustrated by the following examples. The examples assume that P is not a payor with respect to A, the attorney, under section 6041. See section 6041 and the regulations thereunder for rules regarding whether P is required under section 6041 to file information returns with respect to C.

Example 1. One check—joint payees—taxable to claimant. Employee C, who sues employer P for back wages, is represented by attorney A. P settles the suit for \$300,000 that represents taxable wages under existing legal principles and writes a settlement check payable jointly to C and A in the amount of \$200,000, net of income and FICA tax withholding. P delivers the check to A. A retains \$100,000 of

the payment and disburses the remaining \$100,000 to C. P must file an information return with respect to A for \$200,000 under paragraph (a)(1) of this section. P must also furnish an information return to C under section 6051 in the amount of \$300,000.

Example 2. One check—joint payees—excludable to claimant. C, who sues corporation P for damages on account of personal physical injuries, is represented by attorney A. P settles the suit for a \$600,000 damage payment that is excludable from C's gross income under section 104(a)(2). P writes the \$600,000 settlement check payable jointly to C and A and delivers the check to A. A retains \$240,000 of the payment as A's attorney's fees and remits the remaining \$360,000 to C. P must file an information return with respect to A for \$600,000 under paragraph (a)(1) of this section.

Example 3. Separate checks—taxable to claimant. C, a plaintiff in a suit for lost profits against corporation P, is represented by attorney A. P settles the suit for \$300,000. A requests P to write two checks, one payable to A in the amount of \$100,000 for A's attorney's fees and the other payable to C in the amount of \$200,000. P writes the checks in accordance with A's instructions and delivers both checks to A. P must file an information return with respect to A for \$100,000 under paragraph (a)(1) of this section.

Example 4. Check made payable to claimant, but delivered to nonpayee attorney. Corporation P, a defendant in a suit for damages knows that C, the plaintiff, has been represented by attorney A throughout the proceeding. P settles the suit for \$500,000. Pursuant to a request by A, P writes the \$500,000 settlement check payable solely to C and delivers it to A at A's office. P is not required to file an information return under paragraph (a)(1) of this section with respect to A, because there is no payment to an attorney within the meaning of paragraph (d)(4) of this section.

Example 5. Multiple attorneys listed as payees. Corporation P, a defendant, settles a lost profits suit brought by C, for \$1,000,000 by paying a check naming C's attorneys, Y, A, and Z, as payees in that order. Y, A, and Z are not related parties. P delivers the payment to A's office. A deposits the check proceeds into a trust account and makes payments by separate checks to Y of \$100,000 and to Z of \$50,000, for their attorneys' fees. A also makes a payment by check of \$550,000 to C. P must file an information return for \$1,000,000 with respect to A under paragraphs (a)(1) and (b)(1)(i) of this section. A, in turn, must file information returns with respect to Y of \$100,000 and to Z of \$50,000 under paragraphs (a)(1) and (b)(2) of this section if A is not required to file information returns under section 6041 with respect to A's payments to Y and to Z.

Example 6. Amount of the payment—attorney does not provide TIN. Corporation P, a defendant, settles a suit brought by C for \$1,000,000 of damages. C's attorney, A, did not furnish P with A's TIN. P is required to deduct and withhold tax from the \$1,000,000 under section 3406(a)(1)(A) and paragraph (e) of this section. Therefore, P makes the payment by a \$720,000 check naming C and C's attorney, A, as joint payees. P must also file an information return with respect to A under paragraph (a)(1) of this section in the amount of \$1,000,000, as prescribed in paragraph (d)(5) of this section.

Example 7. Home mortgage lending transaction. (i) Individual P agrees to purchase a house that P will use solely as a residence. P obtains a loan from lender L to finance a portion of the cost of acquiring the house. L disburses loan proceeds of \$325,000 to attorney A, who is the settlement agent, by a check naming A as the sole payee. A, in turn, writes checks from the loan proceeds and from other funds provided by P to the persons involved in the purchase of the house, including a check for \$800 to attorney B, whom P hired to provide P with legal services relating to the closing.

(ii) P, not L, is the payor of the payment to A under paragraph (d)(3) of this section. P, however, is not required to file an information return with respect to A under paragraph (a)(1) of this section because the payment was not made in the course of P's trade or business. Even if P made the payment in the course of P's trade or business, P would not be required to file an information return under section 6045(f) with respect to A because P is excepted under paragraph (c)(6) of this section.

(iii) A is not required to file an information return under paragraph (a)(1) of this section with respect to the payment to B because A is not the payor as that term is defined under paragraph (d)(3) of this section. Also A is not required to file an information return under paragraph (b)(2) with respect to the payment to B because A was listed as sole payee on the check it received from P. See section 6041 and its regulations for whether A or L must file information returns under that section. See section 6045(e) and § 1.6045-4 for whether A is required to file an information return under that section.

Example 8. Business mortgage lending transaction. The facts are the same as in *Example 7* except that P buys real property that P will use in a trade or business. P, not L, is the payor of the payment to A under paragraph (d)(3) of this section. P, however, is not required to file an information return under section 6045(f) with respect to A because P is excepted under paragraph (c)(6) of this section. A is not required to file an information return under paragraphs (a) or (b)(2) of this section with respect to the payment to B. See section 6041 and its regulations for whether P or L must file information returns under that section. See sections 6041 and 6045(e) for rules regarding whether A is required to file information returns under those sections.

Example 9. Qualified settlement fund. Corporation P agrees to settle for \$100,000,000 a class action lawsuit brought by attorney A on behalf of a claimant class. Pursuant to the settlement agreement and a preliminary order of approval by a court, A establishes a bank account in the name of Q Settlement Fund, which is a qualified settlement fund (QSF) under § 1.468B-1. A is also designated by the court as the administrator of the QSF. Corporation P writes a \$100,000,000 check in 2003 to A, who deposits the check proceeds into the Q Settlement Fund. In 2004, the court approves an award of attorneys' fees of \$35,000,000 for A. In 2004, Q Settlement Fund delivers a \$35,000,000 check payable to A. P is required to file an information return under paragraph (a) of this section with respect to A for the year 2003 for the \$100,000,000 payment it made to A. The Q Settlement Fund is required to file an information return under section 6041(a) and

§ 1.468B-2(1)(2) with respect to A for the year 2004 for the \$35,000,000 payment it made to A.

Example 10. Bankruptcy trustee—wage garnishment. Individual C files for bankruptcy under Chapter XIII of the Bankruptcy Code, 11 U.S.C. sections 1301-1330. Pursuant to a wage garnishment order, C's employer, P, withholds \$800 from C's earnings. P remits a check for \$800 payable to A, an attorney who was appointed by the United States Bankruptcy Court to act as the trustee of C's bankruptcy estate. P is required to file an information return under section 6045(f) with respect to the \$800 payment it made to A.

(g) *Cross reference to penalties.* See the following sections regarding penalties for failure to comply with the requirements of section 6045(f) and this section:

(1) Section 6721 for failure to file a correct information return.

(2) Section 6722 for failure to furnish a correct payee statement.

(3) Section 6723 for failure to comply with other information reporting requirements (including the requirement to furnish a TIN).

(4) Section 7203 for willful failure to supply information (including a taxpayer identification number).

(h) *Effective date.* The rules in this section apply to payments made during the first calendar year that begins at least two months after the date of publication of these regulations as final regulations in the **Federal Register**.

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

(Filed by the Office of the Federal Register on May 16, 2002, 8:45 a.m., and published in the issue of the Federal Register for May 17, 2002, 67 F.R. 35064)