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Your settlement agreement and IRS Form 1099

Exceptions to Form 1099 reporting of settlement payments

By Robert W. Wood

Most defendants issue IRS Forms 1099 for legal settlements. The form may be issued to the lawyer, the client, or both. Frequently, both the client and the lawyer receive a Form 1099 for 100% of the proceeds, which may make it appear that twice the settlement amount was paid. A big exception to the propensity to issue Forms 1099 for legal settlements is that plaintiffs are *not supposed* to receive Forms 1099 for compensatory personal-physical-injury damages.

In an injury-accident case settling before trial, the lawyer should receive a Form 1099 for the proceeds, but the client should not. If the case settles after a verdict with punitive damages or interest, a Form 1099 is required for the taxable portion, although the extent of the taxable portion can often be debated. In any context, even the most vanilla, it never hurts to be clear in settlement agreements what tax forms will be issued, to whom, and in what amount. Otherwise, you leave it up in the air. I see clients every year who are surprised in January by the tax forms they receive for their prior year settlements.

Unpleasant 1099 surprises

Unpleasant Form 1099 surprises come in many guises. They may receive Forms 1099 they did not expect, or that they did not expect to include the amount attributed to them. A prime example is legal fees, since normally, the plaintiff will receive a Form 1099 for 100% of the settlement, even if a portion is paid directly to their lawyer. Another unpleasant surprise may involve an unexpected form. For example, what if the plaintiff receives a Form 1099-NEC, but was *expecting* a Form 1099-MISC?

Either form presumptively spells taxable income. However, Form 1099-MISC is "other income," which is generic. Form 1099-NEC, on the other hand, means that the payment is non-employee compensation, triggering self-employment tax on top of income tax. The self-employment tax rate is 15.3%, which is a combination of a 12.4% Social Security tax and a 2.9% Medicare tax on net earnings. Only the first $176,100 of earnings is subject to the 12.4% Social Security tax.

However, a 0.9% additional Medicare tax may also apply if your *net earnings* from self-employment exceed $200,000 if you are a single filer or $250,000 if you file jointly. There is no ceiling on that additional 0.9% tax. You can claim that a payment should not be subject to self-employment tax on your tax return and that the Form 1099-NEC you received was a mistake. The IRS may disagree.

Uncertain income

Aside from the personal physical injury context where a Form 1099 should not be issued to the plaintiff, Forms 1099 are likely to be issued in most every case. However, there is another lesser-known category of settlement payments that should also not trigger the form. In practice, many defendants issue Forms 1099 for 100% of the payment no matter what, thinking it is the safest approach.

But if you are a plaintiff, if you have good arguments that you should not receive a 1099, you would rather avoid the form. Receiving a Form 1099 does not automatically mean that a payment is taxable. But a Form 1099 puts the recipient at a comparative disadvantage. This is one of several reasons to think carefully about taxes as you are negotiating a settlement agreement.

Technically, if a defendant does not know whether any of a settlement is income to the plaintiff, the defendants should not issue the plaintiff a Form 1099. There are numerous IRS private letter rulings stating that if the payor does not *know* to what extent a payment is gross income to the recipient, Form 1099 reporting is *not* required. Other than physical injuries, how might a payment not be, or not all be, taxable income to the plaintiff?

Capital recoveries

Apart from physical injury damages, the most common context for this to occur is for recoveries that are capital in nature. Examples are disputes over the sales price for assets sold or for damage to property such as stock or real estate. With capital recoveries, *some* of the settlement may be income to the plaintiff, but the full amount is *not* gross income. Under section 61(a)(3) of the tax code, the plaintiff's gross income includes only the *gain* on the capital recovery.

Gain is only the amount by which the payment exceeds the taxpayer's adjusted tax basis in the property. If you purchased a property for $100, spend $75 improving it, and then sell it for $225, your gross income is $50 of gain ($225 minus $175). The portion of the $225 that reimburses you for your $175 of adjusted tax basis is not a deduction *against* gross income; it is not gross income at all.

The IRS Form 1099-MISC instructions confirm that a payment that is a tax-free recovery of the recipient's adjusted tax basis should *not* be reported on a Form 1099-MISC. The IRS Forms 1099-MISC and 1099-NEC instructions state that payors should "not report damages. . . [t]hat are for a replacement of capital, such as damages paid to a

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buyer by a contractor who failed to complete construction of a building." To the extent a payment recovers the recipient's adjusted tax basis, it is not gross income to the recipient.

Only gross *income* is supposed to be reported to a plaintiff on Form 1099-MISC. When a recovery is taxable as ordinary income, the legal fees and expenses that may be paid out of the recovery do not alter the fact that the full amount of the recovery is gross income, as the Form 1099 regulations specifically confirm. (See Treas. Reg. § 1.6041-1(f).) A deduction for legal fees may reduce the taxpayer's *adjusted* gross income or *taxable* income, but they do not reduce the taxpayer's *gross* income, and it is the latter that is reported on Form 1099.

Legal fees and expenses impact the amount that should be reported on Form 1099 for ordinary income recoveries. The Supreme Court's *Banks* case says that contingent legal fees are gross income to the plaintiff in most cases, and that means the legal fees too must be reported to the plaintiff on Form 1099. However, that is not true with capital recoveries.

In the case of a capital recovery, a plaintiff's legal fees and expenses are capital expenditures that increase their adjusted tax basis, and they thereby decrease the resulting gain on the recovery. (See §§ 263 and 1016(a)(1); Treas. Reg. § 1.263(a)-1(d) & (e); *Woodward v. Comm'r* (1970) 397 U.S. 572; *Alexander v. Comm'r* (1st Cir. 1995) 72 F.3d 938; *Eisler v. Comm'r* (1973) 59 T.C. 634.) Capitalized legal fees and expenses reduce the amount that is properly reported on Form 1099 as gross income to the recipient. A defendant *cannot know* how much to accurately report on Form 1099 in a capital case without knowing the plaintiff's adjusted tax basis in the asset, including any adjusted tax basis created by capitalized legal fees and expenses.

IRS authorities

The IRS has issued numerous private letter rulings stating that when a payor does not know how *much* of a capital payment is gain (i.e., the payor does not know the recipient's adjusted tax basis in their property), Form 1099 reporting is not required or appropriate. (See Revenue Ruling 80-22, 1980-1 C.B. 286; IRS Priv. Ltr. Rul. 201810004 (Mar. 9, 2018); IRS Priv. Ltr. Rul. 201444001 (Oct. 31, 2014); IRS Priv. Ltr. Rul. 200704004 (Jan. 26, 2007); IRS Priv. Ltr. Rul. 199945023 (Nov. 12, 1999); IRS Priv. Ltr. Rul. 9806008 (Feb. 6, 1996); IRS Priv. Ltr. Rul. 9451052 (Dec. 23, 1994); IRS Priv. Ltr. Rul. 9437033 (Sept. 16, 1994); IRS Priv. Ltr. Rul. 9405010 (Feb. 4, 1994); IRS Priv. Ltr. Rul. 9322026 (Mar. 9, 1993); IRS Priv. Ltr. Rul. 9305011 (Feb. 5, 1993).)

Unless the defendant knows what the exact amount of the plaintiff's legal fees and expenses will be in a capital recovery, the defendant does not know how much of the settlement payment is gross income to the plaintiff. As a result, for most capital recoveries, the defendant is *not* required to issue Form 1099-MISC to the plaintiff. (If the capital recovery is paid to the IOLTA account of the plaintiff's attorney, the defendant may nevertheless be required to issue a Form 1099 to the plaintiff's attorney, reporting the settlement in Box 10 as "Gross proceeds paid to an attorney." See IRC Section 6045(f).)

Even so, there can be other tax forms that are appropriate in some cases. Some capital recoveries involving the sale of real estate are to be reported on a Form 1099-S. Defendants who are securities brokers may have to report capital recoveries on a Form 1099-B. Compared with a Form 1099-MISC, which signals ordinary income, reporting a settlement on a Form 1099-S or Form 1099-B more clearly indicates to the IRS that the settlement is a capital recovery.

Understandably, plaintiffs do not want to receive a tax form that may cause the IRS to think they owe more in taxes than they do. But capital recoveries clearly still trigger tax reporting responsibilities on the part of the plaintiff. That is, even if a Form 1099 is not issued or not required, the plaintiff must still report the payment.

Many types of payments are not subject to Form 1099 or other information return reporting rules. They include payments to most corporations and virtually all personal expenses we pay throughout the year. If you pay monthly rent for an apartment, you do not have to issue your landlord a Form 1099, but your landlord clearly still must include the rent in its income.

Negotiating tax issues

Discussing tax issues in a settlement can be difficult. There may already be tension between the parties, and raising tax issues can heighten it. Moreover, the defendant is paying money to resolve a dispute and is unlikely to be anxious to also take on any tax risk. To a defendant, tax requests from plaintiffs may sometimes feel like pouring salt in a wound. A defendant may believe that any tax issues should have been raised earlier, or that a plaintiff's tax requests do not fit the case or the allegations made.

Sometimes, a defendant may feel that the plaintiff is getting an enhanced deal once a plaintiff's tax requests come to light. A defendant may be reluctant to agree on tax-related provisions that put the defendant at any tax risk. Indemnity language for tax issues is common in settlement agreements and can help to ease such concerns. The idea is to require the plaintiff to indemnify the defendant if there are extra taxes, penalties or interest on the defendant because of the tax issues.

An indemnity provision may say that if the plaintiff owes taxes on any of the settlement, fails to pay them, and if there are any adverse tax repercussions on the defendant, the plaintiff should pay them. That kind of tax indemnity seems fair. The defendant may go further to also ask that if a portion of the settlement is later treated as wages by the IRS and the employer faces taxes, interest or penalties, the plaintiff must pay them. Most plaintiffs try to avoid the latter type of

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indemnity provision, since penalties for failure to withhold taxes on wages can be large.

With any tax indemnity provision, as a practical matter, the defendant may believe it is extremely unlikely that they will ever turn to the plaintiff to make good on an indemnity. Even if the defendant did so, the defendant may assume that the plaintiff will not have the wherewithal to pay the indemnity obligation. Some defendants may even fear that they may become embroiled in *another* lawsuit with the same plaintiff.

Negating Forms 1099

The fact that a plaintiff does not want an unnecessary Form 1099 to be issued does not mean that the plaintiff intends to pay no taxes. In a capital recovery, a *portion* of the settlement payment may be taxable gain. But there is usually a portion that is tax basis, such as capitalized legal fees and expenses, that are not gross income to the plaintiff.

There are helpful examples of defendant Form 1099 determinations that can help to confirm the inappropriateness of Forms 1099 in capital cases. In connection with the billions of dollars of legal settlements paid to victims of California wildfires by PG&E and Southern California Edison, both companies (and the related PG&E Bankruptcy and Fire Victims Trust), determined *not* to issue Forms 1099 to fire victims. These defendants issued Forms 1099 to the law firms for the plaintiffs (as gross proceeds paid to an attorney in Box 10 of Form 1099-MISC), but not to the clients.

The companies correctly reasoned that there might be *some* ordinary income in every settlement, but there was also property damage, basis recovery, and capital gain. Absent specific information about what portion of a payment was ordinary income to a wildfire victim and information about the fire victim's adjusted tax bases in their damaged property, both defendants concluded that they could not accurately identify the extent that the settlement or award payments represented gross income to the fire victims. Accordingly, despite the billions of dollars paid out by both Southern California Edison and PG&E, the proper course of action was *not* to issue Forms 1099 to wildfire victims.

Refunds and tax benefit rule

Another situation where a defendant may not know how much of a payment is gross income involves refunds of payments that the plaintiff previously made. Perhaps the most common situation for this to arise with lawsuit settlements is previously paid legal fees. The above-the-line deduction for legal fees only applies in the case of legal fees paid in the same year as the settlement proceeds.

Yet some plaintiffs pay their lawyer hourly over a period of several years before a settlement, and those fees would generally not be deductible when paid outside of a trade or business. However, the portion of a settlement that effectively reimburses the plaintiff for those fees can often be positioned to be tax-free. Notably, though, if the recipient of the refund previously claimed a tax deduction for the payment that is now being refunded, it may *not* be tax-free.

It is a little more complex than asking if the plaintiff deducted the payment. It is relevant if the previous deduction reduced their income tax liability in that year (or a future year if the deduction created a carryforward that offset income in a subsequent tax year). If it did, the refund is generally taxable as ordinary income. The idea is to make up for the tax saved by the prior deduction.

This so-called "tax benefit rule" has been codified into section 111 of the tax code. The tax benefit rule is a pragmatic rule that avoids the inconvenience of amending previous years of tax returns to reverse prior deductions, NOLs and other carryforward items previous deductions may have created. By treating the refund as taxable income in the *current* year, the tax benefit rule also avoids statute of limitations issues.

When a prior deduction was claimed, a key question is just *how much* of a refund is taxable income to the recipient. How this ties into the defendant-payor's reporting issues may be surprising. The IRS has issued numerous rulings over several decades confirming that a payor does not need to determine how much of a refund is taxable to the recipient if the payor does not already know.

When the 1099-M should not be issued

The defendant should *not* issue a Form 1099-MISC when the tax treatment of the refund depends on the recipient's previous tax details the defendant does not know. (IRS Priv. Ltr. Rul. 9322026 (Jun. 4, 1993); IRS Priv. Ltr. Rul. 9340007 (Oct. 8, 1993); IRS Priv. Ltr. Rul. 9806008 (Feb. 6, 1998); IRS Priv. Ltr. Rul. 9853018 (Dec. 31, 1998); IRS Priv. Ltr. Rul. 200023052 (Jun. 9, 2000); IRS Priv. Ltr. Rul. 200025023 (Jun. 23, 2000); IRS Priv. Ltr. Rul. 2000106021 (Feb. 9, 2001); IRS Priv. Ltr. Rul. 200222001 (May 31, 2002); IRS Priv. Ltr. Rul. 200316040 (Apr. 18, 2003); IRS Priv. Ltr. Rul. 200519002 (May 13, 2005); IRS Priv. Ltr. Rul. 200609014 (Mar. 3, 2006); IRS Priv. Ltr. Rul. 200610003 (Mar. 10, 2006); IRS Priv. Ltr. Rul. 200704004 (Jan. 26, 2007); IRS Priv. Ltr. Rul. 200717013 (Apr. 27, 2007); IRS CCA 199919020 (May 14, 1999); IRS CCA 200032041 (Aug. 11, 2000); IRS CCA 201533012 (Aug. 14, 2015). Accord Revenue Ruling 80-22, 1980-1 C.B.) 286.) The exception is a state and local income tax refund. When a state or local government issues a refund, it has a special reporting obligation that does not involve Forms 1099-MISC. Instead, the government entity paying the income tax refund must report the refund on a special Form 1099 for this purpose, a Form 1099-G. (See Section 6050E.)

Conclusion

Plaintiffs and defendants both want to resolve their dispute, but even though tax issues are usually at play, the parties may not take the time to address the tax issues. Plaintiffs, in particular, should consider tax issues before they sign,

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especially if they can improve their tax position in the settlement agreement. This may include specifics about Form 1099 reporting.

A Form 1099 generally does not preclude the plaintiff from taking a tax position that a recovery is not income (such as personal-physical-injury recovery that was nevertheless reported on a Form 1099). A Form 1099 generally also does not preclude a plaintiff from reporting that some or all a payment represents a recovery of tax basis. But nearly everyone would rather *not* have a Form 1099 that will be presumptively viewed by IRS computers as ordinary income.

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