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Beware IRS Form 1099 Mistakes That Trigger Big Taxes On Phantom Income

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Some tax mistakes make it *look* like you collected big, when you really didn't. They can cause tax problems, and it can be hard convincing the IRS that you are right. Take the recent case of a woman who was giddy over winning a \$43 million casino jackpot. Her excitement was short-lived, as the casino claimed the slot machine malfunctioned. Oops, you didn't win after all, they said. The slot machine said it was "printing cash ticket \$42,949,672.76," but it was a mistake. The casino offered her a steak dinner instead, but Katrina Bookman is [suing the Resorts World Casino over the \\$43 million jackpot](#), demanding her payout. She [alleges](#) negligence, breach of contract, and negligent misrepresentation, according to Courthouse News Service.

There's no suggestion that the IRS actually *believes* she got the money in that case. But what if she had received a Form 1099? What if the IRS read about the jackpot and came calling? That can happen with lawsuit recoveries, and it got me thinking: can fake income you *actually* do not receive turn into real taxes? Plainly, the answer is yes, and it happens more times than you might think. At tax time, you probably receive many IRS [Forms 1099](#), and incorrect Forms 1099 are not uncommon.

Most companies interpret the IRS Form 1099 regulations broadly, erring on the side of reporting. When in doubt, issue a Form 1099, many companies say. A few observers may even think of issuing IRS Forms 1099 in a kind of *punitive* way, to turn the tax tables on someone. Every year, check to see if you received any [Forms 1099](#) that you think are wrong. If someone actually *paid* you \$1,000, but *reported* that they paid you \$10,000, you'll have to explain that to the IRS on your return.

Boxer Floyd Mayweather Jr. once [sent an IRS Form 1099 to a strip club to report that he dropped \\$20,000](#). Mayweather Promotions LLC sent the form to the Hustler Club [for \\$20,000](#), mostly cash tips for dancers. The club claimed it didn't see the money paid to the 'independent contractors.' Still, the club must report it. Forms 1099 are critical to tax returns, and you are almost guaranteed an audit or tax notice if you fail to

report one. Each Form 1099 is [matched to your Social Security number](#), so the IRS can easily spew out a tax bill if you fail to report one. It matters a lot, especially [now that the IRS has six years to audit, not three](#).

That's just one example of how a report saying that you were paid can make it awfully tough to prove that you never received the payment. Another circumstance involves the write off of a debt. How can writing off a debt become a tax problem? You can have income despite an absence of cash if you have a discharge of debt. It is also called cancellation of debt or "COD" income.

Loans are not taxed as income. So if a relative or the bank loans you money, you get the cash but do not have income. After all, you have to pay back the debt. But if you are *relieved* of the obligation to repay, so your debt is cancelled? That's usually COD income and it is taxed. Here again, the reports can hurt. There used to be spotty reporting of COD income, with no rigorous reporting system. But today, lenders are required to issue a Form 1099-C reporting this COD income to ensure that you don't omit it from your tax return. There are a few exceptions from the harsh COD income rules. Debts forgiven while you're in bankruptcy—or if not in bankruptcy when you are technically insolvent with more debt than assets—don't count as income.

Phantom income from entities can be a big problem too. Partnerships, limited liability companies (LLCs) and S corporations are pass-through entities. They are generally not taxed themselves; their owners are taxed. Each owner receives a Form K-1 that reports his or her appropriate share of the income (or loss), even if that income is retained by the business and not distributed to the owners. You are obligated to report it, regardless of whether you received any payout. The IRS matches Forms K-1 against individual tax returns. So whatever your phantom income situation may be, plan ahead and be prepared to explain it!

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.