Can Failing to Issue Forms 1099 Preclude Settlement Deduction?

By Robert W. Wood


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It's no secret that information matching has become an increasingly important part of tax administration and enforcement. In many contexts, including the settlement of litigation, the need to determine whether Forms 1099 will be issued and if so, how and to whom, can loom large. Wood examines the commonly held view that a payer that fails to issue a Form 1099 can claim no deduction.

Businesses are frequently sued and regularly settle legal disputes. Because these are adversary proceedings, many businesses may give little thought to tax implications. Surely everything is deductible, they reason. Yet, as with so much else in the tax world, tax professionals know it might not be that simple.

For one, some legal settlements and some counsel fees must be capitalized rather than deducted.[1] Some legal settlements are nondeductible as fines or penalties.[2] Timing questions are also common for cash as well as accrual method taxpayers.[3] It can be tempting to claim deductions before they are truly ripe.

This article focuses on one narrow but surprisingly common question: Does a defendant's failure to issue Forms 1099 for settlement payments preclude a deduction? Answering this question requires a tour through the business expense provisions of the tax law, because the code does not expressly provide a deduction for damages or settlement payments.

Despite the absence of a specific code section, most payments of damages or settlement payments in a business context are generally deductible under the business expense provisions of section 162. If payments of damages or settlement payments are made in connection with the production of nonbusiness income, the payments are usually deductible under section 212. Section 212 allows a deduction for an item if it is paid or incurred in connection with an investment or for the production of income, even though no trade or business is involved.

To be deductible under either section 162 or section 212, damages must be: ordinary, necessary, and reasonable expenses[4]; paid or incurred during the tax year for which a deduction is sought[5]; directly connected with or proximately resulting from the taxpayer's business, income-producing, or investment activity[6]; and currently deductible, rather than a capital expenditure.[7] Finally, they must not be personal in nature.[8]

Ordinary, Necessary, and Reasonable Expenses

The requirement that a damage or settlement payment be ordinary, necessary, and reasonable to be deductible applies under both sections 162 and 212. In *Welch v. Helvering*,[9] the Supreme Court said that an ordinary expense may be irregular in occurrence:

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[1] *See, e.g.*, reg. section 1.263(a)-4(d)(9)(iii).
[2] *See* section 162(f).
[3] *See* reg. section 1.461-1(a)(1), (2).
[4] Section 162(a); section 212.
[5] Reg. section 1.461-1(a)(1), (2).
[6] *Kornhauser v. United States*, 276 U.S. 145, 153 (1928); reg. section 1.212-1(d).
[7] Reg. section 1.461-1(a)(1), (2); section 263.
[8] Section 262(a); reg. section 1.262-1.
[9] 290 U.S. 111 (1933).

> A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. Nonetheless, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.[10]

Also, the courts interpret the necessary prong of sections 162 and 212 broadly, generally to mean customary or appropriate based on business practices.[11] The payment must also be reasonable in amount.[12] Because litigation is by its very nature adversarial, the reasonableness of a payment to dispose of litigation or discharge a judgment is rarely questioned.

Expense Directly Connected to Business

The tax treatment of a settlement or judgment depends on the nexus between the lawsuit and the trade or business of the defendant and the origin of the claims.[13] A settlement or judgment must be paid or incurred in carrying on a trade or business to be deductible under section 162.[14] Thus, in *Kornhauser v. United States*,[15] the Supreme Court allowed deductions for legal and accounting fees incurred defending against a suit, even though the business no longer existed by the time the suit was brought. The Court held that the suit was directly connected with the business, or proximately resulted from it. Therefore, the attorney fees were deductible.

Information Reporting of Settlement Payments

Information reporting issues may arise from legal settlement payments. Section 6041 requires persons engaged in a trade or business to report payments of $600 or more of fixed or determinable gains, profits, and income made in the course of a trade or business. The amount to be reported as paid is the amount includable in the gross income of the payee.[16] If a payment does not represent gross income to the payee, it need not be reported on a Form 1099.[17]

This turns out to be a critical rule in much litigation. In many cases a plaintiff will claim that some portion of a lawsuit recovery constitutes compensation for personal physical injuries or physical sickness. If true, no Form 1099 for that portion of the settlement payment should be issued.[18] This can cause friction between plaintiffs and defendants, with plaintiffs asking that no Form 1099 be issued and many defendants believing that the absence of a Form 1099 will preclude a deduction.

The code and regulations do not expressly condition the ability to claim a deduction on the reporting of that item on Form 1099. Thus, the common fear that a defendant will not be able to claim a tax deduction for a payment that has not been reported on a Form 1099 appears to be unjustified. Substantiation is required in any case, but it can be provided in other forms.

A taxpayer must retain records that substantiate the taxpayer's right to the deduction.[19] The regulations generally provide that any person or entity subject to federal income tax or required to file an information return must keep permanent books of account or records. These documents must establish the amount of gross income, deductions, credits, or other matters required to be shown in any tax or information return.[20]

Substantiating Deductions

Generally, a taxpayer proves payment of an amount by producing a canceled check. However, account statements may also be accepted as proof of payment for purposes of substantiating federal income tax deductions.[21] For example, an account statement prepared by a financial institution showing a check clearance (that is, a decrease in the account holder's balance) should be accepted as proof of payment if the statement shows the:

- check number;
- amount of the check;
- date the check amount was posted to the account by the financial institution; and
- name of the payee.

Similarly, the IRS has said that it will accept an account statement showing an electronic funds transfer if the statement shows the:

- amount of the transfer;
- date the transfer was posted to the account by the financial institution; and
- name of the payee.

Interestingly, a prepared but unfiled Form 1099, by itself, has been held to be insufficient evidence to

[10] *Id.* at 114.
[11] *See Lily v. Commissioner*, 343 U.S. 90 (1952).
[12] *See* reg. section 1.212-1(d).
[13] *United States v. Gilmore*, 372 U.S. 39, 49 (1963); *Hort v. Commissioner*, 313 U.S. 28 (1941).
[14] *See Kornhauser*, 276 U.S. 145 (1928).
[15] *Id.*
[16] Reg. section 1.6041-1(f).
[17] Reg. section 1.6045-5(f), Example 2; LTR 9601035, *Doc 96-1035*, *96 TNT 5-54*.
[18] *See* 2012 instructions to Form 1099-MISC, "Miscellaneous Income."
[19] Section 6001; reg. section 1.6001-1(a).
[20] Reg. section 1.6001-1(a).
[21] Rev. Proc. 92-71, 1992-2 C.B. 437.

substantiate a deduction.[22] But the courts have sustained deductions for payments for which the taxpayer could not produce an information return. Of course, it is necessary for the taxpayer's records to otherwise be sufficient to establish the deduction.

For example, in *Westby v. Commissioner*,[23] the IRS disallowed many of the taxpayer's claimed deductions. The Tax Court, however, reversed this determination. It held that the Service's disallowance of the deductions was unwarranted and arbitrary. The IRS attempted to justify its conduct by pointing to the taxpayer's failure to introduce into evidence all of her payroll records or her Forms W-2.

Rejecting the IRS's argument, the Tax Court sustained the taxpayer's deductions for employee compensation based on her testimony and other documents. This evidence established that she paid salaries, employment taxes, and employee benefits during the years at issue. The taxpayer's expense records don't appear to have been well organized, consisting of canceled checks, cash receipts, credit card statements, and similar documents. The court acknowledged that although these records might not have been kept in a form pleasing to the IRS revenue agent, they were adequate to satisfy the books and records requirement under the regulations.[24]

Whether or not information reports are relevant to claiming deductions, clearly one should not ignore the information reporting requirements. One who is required to report a settlement payment on a Form 1099 must file the form with the IRS and furnish a copy to the payment recipient.[25] Failure to do either of these things results in a separate penalty under section 6721 or 6722.

First, failure to properly file an information return (for example, a Form 1099) with the IRS can result in penalties under section 6721. Penalties may be applied under section 6721 for failure to furnish the IRS with an information return by the required filing date,[26] failure to include all the information required on an information return, or furnishing an information return with incorrect information.[27]

The amount of the penalty varies depending on the payer's annual gross receipts and the number of failures. Effective for information returns required to be filed with the IRS on or after January 1, 2011, the penalty is generally $100 for each return, up to a maximum of $1.5 million in penalties for any calendar year.[28] For payers with gross receipts less than $5 million for the tax year, the $1.5 million maximum penalty is reduced to $500,000.[29]

Failure to file a correct statement with the IRS is likely to be linked to a corresponding failure to provide the recipient of the income with a correct information statement. Consequently, the additional penalties imposed under section 6722 can cause the penalties to double in amount.

Section 6722 penalties may be assessed for failure to timely provide the payee with the payee statement by the due date (for example, by January 31 following the tax year for payees receiving a Form 1099-MISC); failure to include all the information required on a payee statement; or furnishing a payee statement with incorrect information.[30] Similar to the penalties for failure to file a timely and correct return with the IRS, the penalty a payer can incur under section 6722 is generally $100 for each payee statement, up to a maximum of $1.5 million in penalties for any calendar year.[31]

Penalties under sections 6721 and 6722 may be reduced or even excused if the errors are corrected, inconsequential, or due to reasonable cause.[32] However, if any failure to file a correct information return is due to intentional disregard of either the filing or correct information requirements, the penalty is generally the greater of $250 per information return or 10 percent of the aggregate amount of the items required to be reported correctly.[33] A similar penalty applies to any failure to provide timely and correct payee statement,[34] so that in cases when both penalties apply, the payer faces penalties of the greater of $500 or 20 percent of the aggregate amount of the items required to be reported correctly. There is no cap on the maximum penalty.

Conclusion

Keeping good records is not only good practice but virtually a necessity. This is so whether or not Forms 1099 are issued. Indeed, it may seem silly to note the items that should be retained when a Form 1099 *has not* been issued, because they are precisely the same items that should be retained when such a form *has* been issued.

A defendant should keep litigation records showing the ordinary and necessary character of the

[22] *Weatherly v. Commissioner*, T.C. Memo. 2011-206, *Doc 2011-18245*, *2011 TNT 166-4*.
[23] T.C. Memo. 2004-179, *Doc 2004-15883*, *2004 TNT 150-8*.
[24] *See* reg. section 1.6001-1(a); *Jackson v. Commissioner*, 59 T.C. 312, 317-318 (1972).
[25] *See* section 6041(a), (d).
[26] Section 6721(b).
[27] Section 6721(a).
[28] *Id.*
[29] Section 6721(d)(1). The gross receipts test is met if the person's gross receipts for the three most recent tax years do not average more than $5 million. Section 6721(d)(2).
[30] Section 6722(b); reg. section 301.6722-1(a)(2).
[31] Section 6722(a).
[32] Section 6721(b), (c); section 6722(b), (c); section 6724.
[33] Section 6721(e).
[34] Section 6722(e).

litigation, as well as a copy of the settlement agreement and a copy of the payment detail, including canceled checks or wire transfer details. Rev. Proc. 92-71 includes a helpful recitation of substantiation documentation.

Finally, retain records in cases when Forms 1099 were not issued because of plaintiff negotiations or agreements about section 104 allocations. The records could be helpful in avoiding liability for penalties for failure to issue the forms. In 30 years of practice, I have never seen the IRS assess, much less collect, the penalty for intentional failure to issue a Form 1099. Yet it is appropriate to be careful and reflective. Failure to properly file information returns like a Form 1099 might result in the imposition of penalties under sections 6721 and 6722.

In sum, does no Form 1099 mean no tax deduction? Hardly. This could be useful information for companies that have failed to issue Forms 1099. It could also help companies that are asked not to issue a Form 1099 in a settlement, such as when the plaintiff is claiming a section 104 exclusion but the defendant does not agree that the payment is clearly excludable under the law and the facts.