

Can Plaintiffs Avoid IRS Forms 1099 On Legal Settlements?

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 Forms 1099 for 100% of the proceeds. This can make it appear that twice the settlement amount was paid, but such duplicate reporting is usually required in the case of most fully taxable settlements.

The biggest exception 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, though the amount that is taxable can often be debated.

In any settlement, 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 many clients every year who are surprised in January by the tax forms they receive for their prior year settlements.

Unpleasant Surprises

Unpleasant Form 1099 surprises come in many guises. Plaintiffs may receive Forms 1099 they did not expect, or with amounts they did not expect. A prime example is legal fees. Normally, the plaintiff's Form 1099 will include 100% of the settlement, even if the fees are paid directly to their lawyer. Another unpleasant surprise may involve an unexpected variety of Form 1099.

What if the plaintiff receives a Form 1099-NEC, but was *expecting* a Form 1099-MISC? Either form spells taxable income, but Form 1099-MISC is "other income," which is generic. Form 1099-NEC, on the other hand, means a 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, an .9% additional Medicare tax applies if your net earnings from self-employment exceed \$200,000 for a single taxpayer or \$250,000 for a married couple. There is no ceiling on that additional .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 was a mistake. However, the IRS may disagree.

Uncertain Income

Aside from personal physical injury settlements, Forms 1099 are issued in most every case. However, there is another category of settlement payments that should also not trigger the form. If you are a plaintiff with good arguments that you should not receive a 1099, you would rather avoid the form since Form 1099 puts you at a comparative disadvantage.

This is one reason 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 a Form 1099. Numerous IRS rulings say that if a payor does not know how much of a payment is gross income, Form 1099 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 is recoveries that are capital in nature. Examples are disputes over the sales price of assets or damage to property like stock or real estate. Say you are suing over a defective home construction or remodel, damage to your property by a neighbor, or caused by a fire. Or perhaps you are suing your investment adviser over bad account management.

All of these are fundamentally disputes that are wholly or partially capital in nature, where your tax basis is relevant. Some of the settlement may be income to the plaintiff, but the full amount is *not* gross income. For 1099 purposes, the plaintiff's gross income includes only the *gain* on the capital recovery, and that is only the amount by which the payment exceeds the taxpayers' adjusted tax basis in the property.

Say that you purchased a property for \$100, spent \$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. And what IRS Form 1099 are supposed to report is *only* gross income.

The IRS Form 1099-MISC instructions say expressly 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 buyer by a contractor who failed to complete construction of a building." A payment of the recipient's adjusted tax basis is not gross income, so it does not belong on a 1099.

When a settlement is ordinary income, the legal fees and expenses that may be paid out of the recovery do not change the fact that the entire settlement is gross income. That means it all belongs on Form 1099. *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. It is the latter that is reported on Form 1099.

However, capital recoveries are different. Here, a plaintiff's legal fees and expenses are capital expenditures that increase the plaintiff's adjusted tax basis. They then decrease the resulting gain the settlement. 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.

The legal expenses are almost always a moving target as a case is moving toward settlement. So the defendant is simply not supposed to issue a Form 1099 to the plaintiff where some or all of the proceeds are capital in nature.

The IRS has confirmed 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. Unless the defendant knows what the exact amount of the plaintiff's legal fees and expenses, the defendant does not know how much of the settlement payment represents gross income to the plaintiff. As a result, the defendant is *not* required to issue Form 1099-MISC to the plaintiff.

There is voluminous practical precedent for this rule. For example, there were billions of dollars of legal settlements paid to victims of California wildfires by PG&E and Southern California Edison. Both companies determined *not* to issue Forms 1099 to fire victims. They 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. Because of tax basis and other issues, both defendants concluded that they could not accurately identify the extent that the settlements represented gross income to the fire victims.

Taxes and Indemnity

Discussing tax issues in a settlement can be difficult. The defendant is paying money to resolve a dispute and is unlikely to want to take on any tax risk. Indemnity provisions are 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 the settlement and fails to pay them, and if there are any adverse tax repercussions on the defendant, the plaintiff should pay them. That seems fair. The defendant may go further to also ask (such as in an employment case) 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 indemnity provision, since penalties for failure to withhold taxes on wages can be large. With any tax indemnity provision, as a practical matter, it may be extremely unlikely that the defendant will ever turn to the plaintiff to make good on an indemnity obligation. The plaintiff may not have the wherewithal to pay the indemnity obligation, and some defendants may even fear that they could become embroiled in *another* lawsuit with the same plaintiff.

Conclusion

Plaintiffs should consider tax and Form 1099 issues before they sign a settlement agreement. A Form 1099 does not preclude the plaintiff from taking a later tax position that a recovery is not income or is capital gain. But nearly everyone would rather *not* have a Form 1099 that will be viewed by IRS computers as ordinary income.

Robert W. Wood practices law with www.WoodLLP.com, and is the author of "*Taxation of Damage Awards & Settlement Payments*" (www.TaxInstitute.com). This discussion is not intended as legal advice.