

IRS Forms 1099 for lawsuit settlements often total 200% of the payment

By Robert W. Wood

If you received a lawsuit settlement, you may also have received an IRS Form 1099 the following January, a kind of reminder not to forget to pay your taxes.

IRS Forms 1099 feature prominently in lawsuit settlements. Sometimes they are expressly mentioned in the settlement agreement. But even where they are not mentioned, they conventionally are issued to the plaintiffs, the plaintiffs' lawyers, or both. The forms generally report income and are matched to tax returns based on Social Security Numbers.

That makes them extremely important at tax time. When \$600 or more is paid in the course of a payor's trade or business for many types of income, the payor must generally issue a Form 1099 to the recipient, with a copy filed with the IRS. There are different versions of the form for different types of income. The most common in the lawsuit context is Form 1099-MISC, for miscellaneous. But there is another form now commonly seen with lawsuits, Form 1099-NEC.

What is the difference? Form 1099-MISC is for a payment of "other income," which can be just about anything. Form 1099-NEC is for nonemployee compensation. The difference is important because a Form 1099-NEC tells the IRS that they should be collecting self-employment taxes on top of income taxes. It is appropriate for a company to issue a Form 1099-NEC if you are an independent contractor and rendered services for pay. If you sued for your pay in that context, the Form 1099-NEC is still appropriate.

However, suppose that you were an employee, and you sued for wrongful termination and emotional distress. When you settle, the company will most likely treat part of the funds as wages on a Form W-2, and the rest on a Form 1099. You want the Form 1099 to be a Form 1099-MISC, not a Form 1099-NEC, because you do not want to pay self-employment tax on the nonwage payment. If you don't specify, you may end up with a Form 1099-NEC in January that may be hard to undo.

Negotiating Forms 1099 in settlement agreements

If you are a plaintiff or a plaintiff's lawyer, thinking about tax reporting before finalizing a settlement agreement is good business. Considering the importance of these little forms to the tax treatment of payments, it is surprising that many legal settlement agreements do not say anything about whether any tax forms will be issued to the plaintiff or his lawyer. Yet the normal practice for many defendants when a settlement is paid to the plaintiff's lawyer or the lawyer's trust account is to issue a Form 1099 to the plaintiff, and a Form 1099 to the lawyer, often each for 100%.

That may sound like double counting, but it is generally required under current tax law, unless the payment to the plaintiff is fully tax free. How could the payment be fully tax free? There are a few arcane ways it might be, but the main way is if the payment represents compensatory damages for

personal physical injuries. In a typical injury case like an auto accident, so long as there are no punitive damages or interest.

Yet, even if you are certain you qualify, it is never a bad idea to get a written commitment from the other side about the tax forms. I see cases every year that I think should be tax-free but that end up getting reported to plaintiffs on Forms 1099. It may be because of insurance companies, cautious defendants or lawyers, or just a glitch caused when the tax forms are issued by some outside accountant or vendor who has no details about the payment.

After a settlement agreement is signed, the plaintiff has no leverage about whether a Form 1099 will be issued, to whom, and for what amount. And even if it seems clear to you that no Form 1099 should have been issued, disagreements about appropriate Form 1099 reporting are extremely common. Therefore, the best time to raise the question about tax reporting is before the settlement agreement is signed. Ideally, the parties should agree in the settlement agreement exactly what forms will be issued, to whom, and in what amounts.

Sometimes, you even want to specify which box to complete on a particular form. That way, if a form is issued in January that is at odds with what the agreement says, you can get it corrected. In my experience, if you do not have an express provision in the settlement agreement that makes clear what Forms 1099 will or will not be issued, getting a defendant to correct any form they send is extremely difficult.

How much to report?

Many defendants issue a Form 1099 for every settlement dollar when the settlement is made as part of the defendant's trade or business. Except in clear physical injury cases, most do duplicate reporting, so that a check payable to plaintiff and lawyer will be 100% reported to the plaintiff, and 100% reported to the lawyer. That is what the IRS generally requires for legal settlements. Many defendants feel that it is safer from a tax perspective to avoid any doubts about whether they have reporting duties by always sending the forms.

But isn't sending two Forms 1099 for 100% double counting? Doesn't it look like 200% of the settlement was paid? Yes, but the IRS's theory is that the defendant may not know how much of the money the lawyer vs. the client is ultimately receiving. If the settlement check goes jointly to the lawyer and client, or just to the lawyer's trust account, duplicate reporting is required. You can cut down on this with separate checks to the lawyer and client if you wish.

But even that is unlikely to avoid having the IRS attribute to plaintiffs the payment of legal fees to their lawyer. The tax treatment of legal fees, and of payments to lawyers connected with their clients, was controversial for decades. At one time, there was a split in the Circuit Courts about whether clients were treated as receiving taxable income when payment for legal fees went directly to their lawyer.

Then, in 2005, the U.S. Supreme Court decided *Commissioner v. Banks*, 543 U.S. 426, which confirmed that a plaintiff's gross income generally includes the portion of the recovery paid to their lawyer as legal fees. Consistent with the *Banks* decision, the Form 1099 regulations say that a Form 1099 issued to a plaintiff for a payment that is includible in the plaintiff's gross income must include the gross amount paid, including the amount paid to their lawyer. See Treas. Reg. §§1.6045-5(f), Ex. 1.; 1.6041-1(f).

Therefore, having the settlement paid to the attorney's trust account, or having the attorneys' fees paid separately, usually does not avoid Form 1099 reporting to the plaintiff. The attorney is the plaintiff's agent, and amounts paid to the attorney on the plaintiff's behalf are treated as also paid directly to the plaintiff for Form 1099 reporting purposes. Of course, as a practical matter, a great many plaintiffs ask the reasonable question, "How can I be taxed on money I did not receive?"

After all, most lawyers in contingent fee cases understandably want to have their worst-case tax position to be paying tax on every dollar they collect, but not also on every dollar their lawyer collects. Plaintiffs with ordinary taxable recoveries (including wage payments) must generally find a way to claim a tax deduction for the fees and expenses.

Example: Defendant deposits \$100k gross settlement in plaintiff counsel's IOLTA account. The plaintiff's counsel retains \$40,000 for contingent fees and expenses, then distributes a \$60,000 net recovery to the plaintiff. The plaintiff receives a Form 1099 (or Form W-2 for wage payment) for the full \$100,000 from the defendant, even though defendant paid into the IOLTA account, not directly to the plaintiff. The plaintiff should include \$100,000 in gross income, and claim a tax deduction, if possible, for the \$40,000 in fees retained by their counsel.

Which plaintiffs qualify for a tax deduction for their fees? Plaintiffs in employment cases, civil rights cases, and most types of whistleblower cases qualify. But only if the legal fees are paid in the same year as the settlement, as occurs in a typical contingent fee case. If the plaintiff has been paying fees hourly over several years, the tax issues are thorny.

Similarly, outside of employment, civil rights and whistleblower cases, qualifying for a tax deduction for legal fees is difficult. Surprisingly, it can even be a problem in personal physical injury cases if punitive damages or interest are awarded. Say that a case settles after trial, 50% of the damages are compensatory, and 50% are punitive damages and interest. The punitive damages and interest are fully taxable to the plaintiff, and they have to include 100%, including the related legal fees.

With a 40% contingent fee, the IRS requires you to allocate the legal fees pro rata. So the question is whether the plaintiff can deduct the portion of the legal fees that are attributable to the punitive damages and interest. Most tax preparers and tax lawyers would probably say no, so you have to be creative to be able to support a deduction.

The bottom line is what whatever your circumstances are in settling a lawsuit, it pays to think about taxes - and the tax reporting forms you might receive - before you sign a settlement agreement.

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