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Robert W. Wood

THE TAX LAWYER

IRS Forms 1099 For Lawsuit Settlements Can Total 200% Of Amount Paid

Robert W. Wood
Senior Contributor

Robert W. Wood is a tax lawyer focusing on taxes and litigation.



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If you received a lawsuit settlement, you may *also* have received an IRS Form 1099 the following January, a reminder not to forget to pay your taxes that goes to you and the IRS. IRS Forms 1099 feature prominently in lawsuit settlements. Sometimes they are expressly mentioned in the settlement agreement, but even when 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 business for many types of income, the payor must generally issue a Form 1099 to the recipient, with a copy to 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 non-employee 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 appropriate.

However, suppose that you were an employee suing 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 non-wage payment. If you don't specify, you may end up with a Form 1099-NEC in January that may be hard to undo. Check out many [tax myths about Forms 1099 here](#).

Negotiating Forms 1099 In Settlements

If you are a plaintiff, thinking about tax reporting before finalizing a settlement agreement is good business. It pays to review the specific [Form 1099 rules for settlements and legal fees](#). Considering the importance of these 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 lawyer. Yet the normal practice for many defendants 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 the tax law, unless the payment to the plaintiff is fully tax free. How could the payment be fully tax free? 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, the damages should be tax free as [explained here](#).

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 are 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 it 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 business. With payments of [settlements and legal fees](#), except in clear physical injury cases, most defendants do duplicate reporting, so that a check payable jointly to plaintiff and lawyer will be 100% reported to the plaintiff, and 100% reported to the lawyer. But 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 or the client is ultimately receiving.

If the settlement check goes jointly to 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 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 a 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 settlement 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, may 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, many plaintiffs ask the reasonable question, "how can I be taxed on money I did not receive?"

Plaintiffs understandably want their worst-case tax position to be paying tax on the dollar they collect, but not on the fees 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.

Which plaintiffs qualify for tax deductions for their fees? Plaintiffs in employment cases, civil rights cases, and most types of whistleblower cases qualify, and you can read a list of [ways to deduct legal fees here](#). But the legal fees need to be 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.