

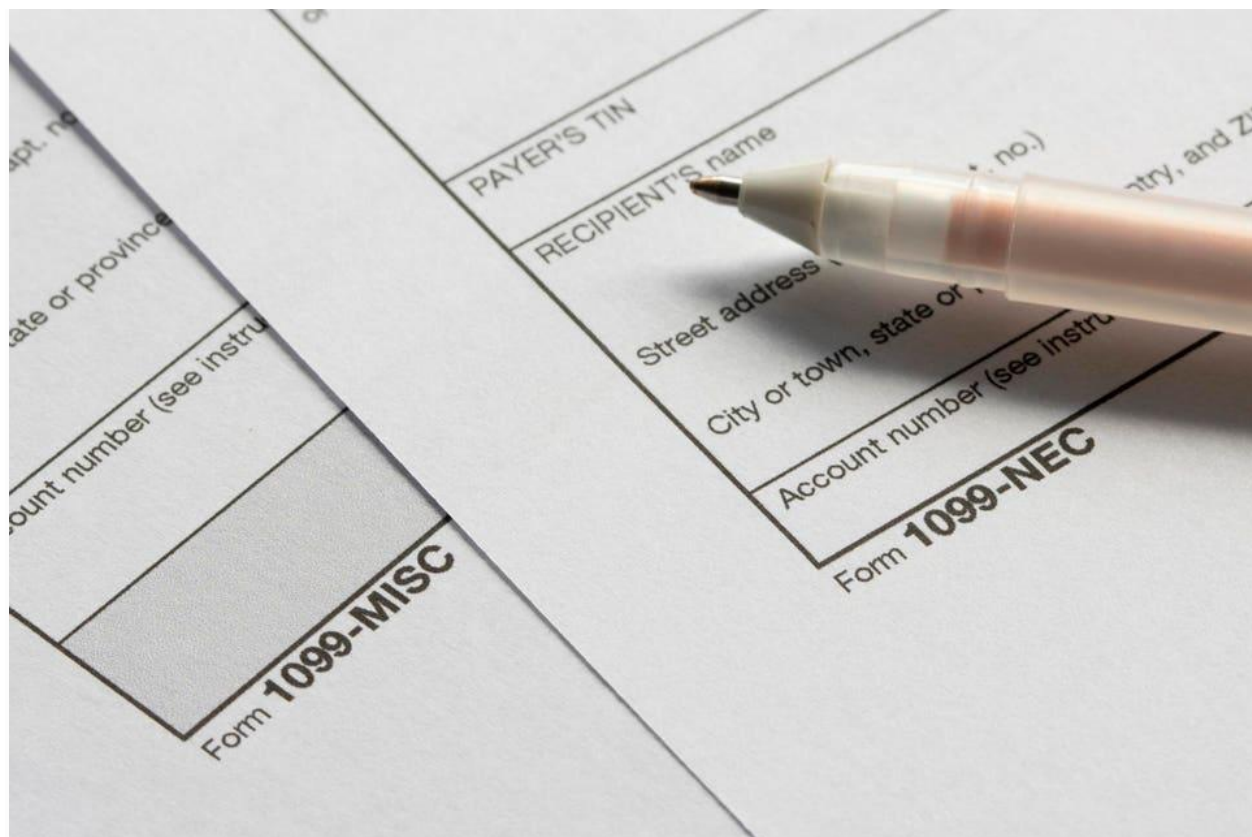


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January 26, 2026

## Lawsuit Settlement Form 1099 Requires Special Care On Your Taxes



If you received a lawsuit settlement, you are likely to receive an IRS Form 1099, a 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 when they are not, 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. The dollar threshold goes up to \$2,000 for settlements paid in 2026, but right now, we are dealing with 2025 payments and 2025 Forms 1099. The biggest exception to the Form 1099 rules for lawsuit settlements is if your case was 100% compensatory damages for physical injuries. Compensatory damages for personal physical injuries are tax free under [Section 104 of the tax code](#). Punitive damages and interest are always taxable.

Form 1099-MISC or 1099-NEC?

There are different versions of the form for different types of income, and 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 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 Settlement Agreements

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](#).

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.

### 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.

If the settlement check goes jointly to lawyer and client, or just to the lawyer's trust account, duplicate reporting is required. Separate checks to lawyer and client can help, but it is unlikely to avoid having the IRS attribute to plaintiffs the payment of legal fees to their lawyer. 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.

As a result, IRS 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).

Plaintiffs with taxable recoveries want to claim a tax deduction for the fees and expenses, but which plaintiffs qualify? Plaintiffs in employment cases, civil rights cases, and most types of whistleblower cases qualify, and you can read a list of [how to deduct legal fees under current law](#), 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. 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.