



Tax Matters Robert W. Wood

WOOD LLP

Love them or hate them

THE TAX REALITY OF IRS FORMS 1099

On some level, everyone knows what IRS Forms 1099 are about. A Form 1099 is one of those annoying little reminders that someone paid you and that you should report it on your tax return. A copy is sent to you, and the IRS and the state receives a copy too. The whole idea of these ubiquitous forms is so that IRS computers can churn out tax notices if you forget to report one.

Yet despite their importance, many of us do not pay adequate attention to them. You may not think about them until around April 15, when you are doing your taxes, when hopefully you have set aside the tax forms that show up in the mail. In most cases, the forms arrive around the end of January, reporting payments for the prior year. Yet many people do not even open the envelope until the April 15 tax-return deadline is near.

If you put your tax return on extension until October, you might even put off looking at your forms until then. That's a mistake, as errors on the forms are common, and they are easier to correct if you check them promptly on arrival. The error might be the wrong dollar amount. Or the error might be the fact that the form was issued at all.

I see cases every year where the defendant agreed in a signed settlement agreement *not* to issue the plaintiff a Form 1099, but someone slipped up. It is often possible to get that corrected if you address it promptly. If you wait for months, more damage can be done. Another common Form 1099 error is the wrong form. Every year, I see plaintiffs who *expected* a Form 1099-MISC, but who receive a Form 1099-NEC instead. The latter triggers self-employment taxes on top of income tax.

This can often be corrected, but you need to ask, and asking promptly is best. Speaking of Forms 1099 that should not be issued, every year I see a few clients who receive Forms 1099 from their own lawyers. Suppose that a case settles for \$1M, and the lawyer's fee is \$400k. The funds are sent to the law firm, at which point the law firm subtracts the \$400k fee,

and remits \$600k to the client.

Is the lawyer obligated to issue the client a Form 1099 for \$600k? No, and yet some lawyers mistakenly do this. For Form 1099 reporting duties, the "payor" of the money is the defendant, not the lawyer. Regardless of whether the defendant does or does not issue a Form 1099 to the plaintiff, the lawyer should not issue a Form 1099 to their own client.

Just to take the point one step further into Wonderland, think about the ramifications. The plaintiff in this example might receive a Form 1099 from the defendant for \$1M. That is so, because unless the money is for compensatory physical injuries, the Form 1099 issued to the plaintiff is required to include the gross settlement amount, including the legal fees. Then, if the lawyer mistakenly *also* issues the client a Form 1099 for the \$600k net proceeds, the IRS will think the client received \$1.6M.

If you receive a check for \$600k and you receive Forms 1099 that total \$1.6M, you need some tax help, and you may not be happy. In short, don't ignore Forms 1099 at settlement time, or any time after. Each one includes your Social Security number and will be matched against your tax return by IRS computers.

What if you receive a taxable payment but the person who paid you forgets to issue you a form? It reminds me of that old puzzler, "If a tree falls in a forest and no one is around to hear it, does it make a sound?" If you do not receive a Form 1099, is it income in the first place? Can you argue that since there was no Form 1099, it must not be taxable? How will the IRS know about the payment if there is no Form 1099?

These questions come up more than you might think, and it might be tempting to play dumb. Suppose that you earned \$50,000 as an independent contractor, but they forgot to send you a Form 1099. Can you ignore it, the tree falling in the forest that no one hears? No, the IRS says that income is income, whether you receive a Form 1099 or not. In fact, numerous kinds

of payments are taxable, even though there is no requirement for a Form 1099 to be issued.

With legal settlements in particular, some plaintiffs have argued with the IRS or in Tax Court that since the defendant did not issue a Form 1099, they must have intended the payment to be nontaxable. There are a surprising number of tax cases on this issue, and the argument has usually not fared well. When it comes to legal settlements, the IRS says that the payor's intent is a key indicator of how it should be taxed.

Often, the character of a settlement payment hinges on the dominant reason the payor made the payment. Settlement agreement language is surprisingly important, and in an audit, the IRS may not look beyond a well-worded settlement agreement. However, the IRS can determine the payor's intent by examining the entire record. A payor's failure to issue a Form 1099 alone is not proof that a payment is not taxable.

If you do receive a Form 1099 and you do not include the reported item on your tax return, you can expect an IRS notice or tax bill. In fact, you're almost guaranteed an IRS notice if you fail to report a Form 1099. What if you've moved and the form never catches up with you? Even if it is sent to your old address, the information will be reported to the IRS based on your Social Security number. That makes it wise to update your address with payers, and put in a forwarding order with the U.S. Post Office. It's also a good idea to file an IRS Form 8822 to change your address.

Suppose that you believe that a Form 1099 was supposed to be issued, such as for a settlement payment, but the form never arrived? Should you follow up with the company and ask for it? My usual answer is no. If you know about the payment, you should just report it. You do not need the Form 1099 to file your return. Forms 1099 are not filed with tax returns in any event.

What's wrong with asking for the form? For one thing, the Form 1099 may have been issued and lost in the mail or

sent to your old address. If you ask for the form, the company may issue a *second* Form 1099. In that event, The IRS may believe that you received two payments. Besides, if you really want to know if a Form 1099 was issued to you, there is an alternative.

Ask the IRS for a transcript of your account. You can do this online with the IRS so that you can see all Forms 1099 that were issued under your Social Security number. That is better than asking for a Form 1099, especially for something like a lawsuit recovery. In any event, getting a transcript is a useful way to double-check your information.

Lastly, while I stress the importance of Forms 1099, and how seriously they should be taken, “reporting” a Form 1099 does not always mean that you must treat it as taxable income. After all, some payments of gross income trigger a Form 1099, but may not be taxable income. A plaintiff in a lawsuit usually receives a Form 1099 for the gross settlement, including the attorney fees. But usually, the plaintiff should be able to find a way to deduct or offset the legal fee portion of the settlement.

What’s more, some plaintiffs have viable arguments that some or all of a settlement payment should be excludable for physical injuries or physical sickness,

despite the Form 1099. The fact that a Form 1099 was issued for the payment can impact that argument, but it does not foreclose the plaintiff from claiming the exclusion.

Bottom line? Pay attention to IRS Forms 1099 and be careful out there. ♦

Rob Wood is a tax lawyer at Wood LLP. He has a varied tax practice but is best known for advising on the tax treatment of legal settlements, litigation finance and qualified settlement funds. He is the author of several tax books on these topics, writes frequently for Tax Notes, Forbes and other publications, and serves as an expert witness on tax issues.