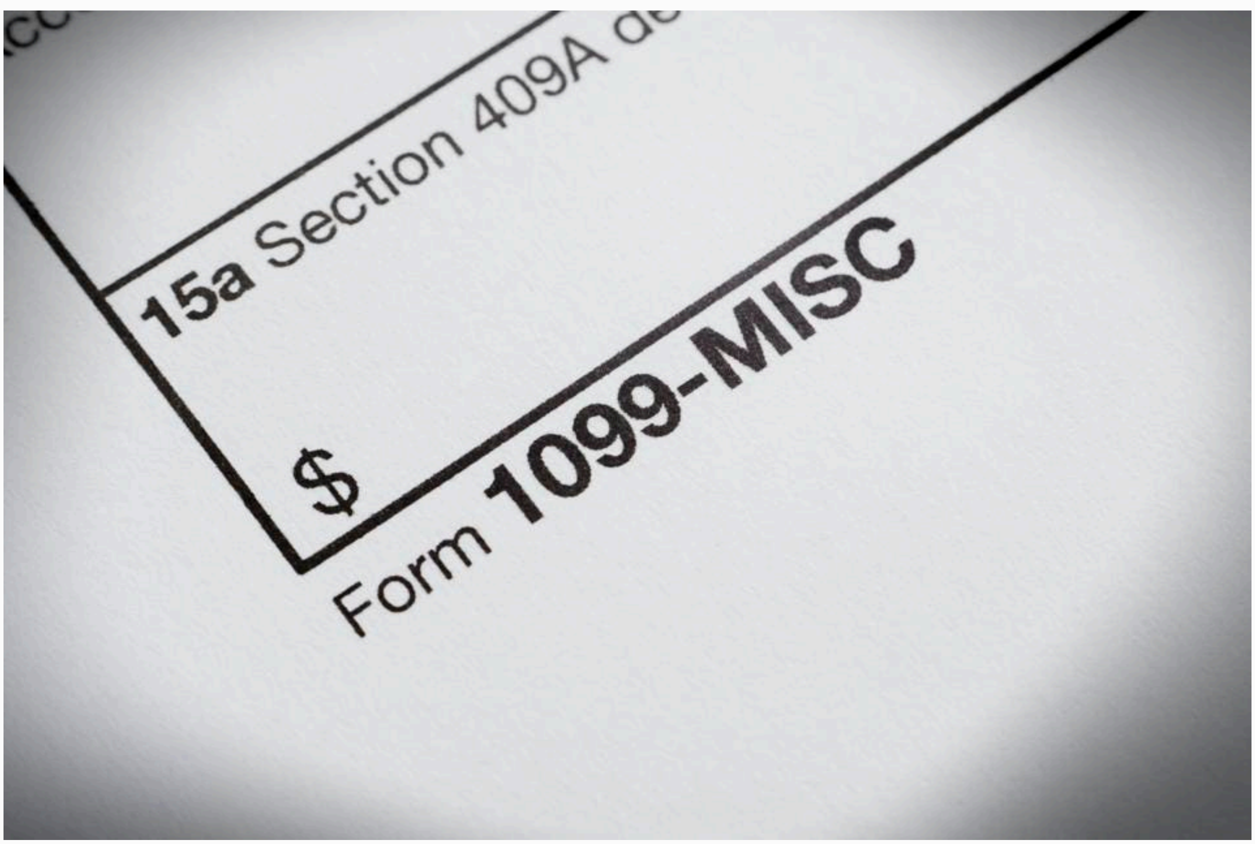
Forbes

Robert W. Wood
THE TAX LAWYER

Most Lawsuit Settlements Trigger An IRS Form 1099, But Not These Two

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



May 17, 2025

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 a Form 1099 for 100%, making it appear that the settlement amount was 200% of the payment. The biggest exception is 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 plaintiff should not.

If the case settles after a verdict with punitive damages or interest, a Form 1099 is required for the taxable portion, although the amount that is taxable can often be debated. In even the most vanilla case, 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. Many plaintiffs are surprised in January by the tax forms they receive for their prior year settlements. There are plenty of myths about IRS Forms 1099, and it pays to avoid surprises if you can.

Unpleasant Surprises

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 type of Form 1099.

What if the plaintiff receives a Form 1099-NEC, but was *expecting* a Form 1099-MISC? Either form spells income, but Form 1099-MISC is "other income," while Form 1099-NEC means 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 but 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 a defendant does not know whether any of a settlement is income to the plaintiff, the defendant should not issue a Form 1099. Other than physical injuries, how might a payment not be, or not *all* be, taxable income to the plaintiff?

Capital Recoveries

The most common are recoveries that are capital in nature. After all, the IRS taxes legal settlements, but some are capital gain. 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, or damage to your property. Or perhaps you are suing your investment adviser over bad account management.

All of these are fundamentally disputes that are capital in nature, where your tax basis is relevant. Some of the settlement may be income to the plaintiff, but the full amount should not be. 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. It is not gross income at all.

IRS Form 1099 are supposed to report *only* gross income. The IRS Form 1099-MISC instructions say that a payment that is a tax-free recovery of the recipient's adjusted tax basis should *not* be reported on a Form 1099. The IRS Forms 1099-MISC and 1099-NEC instructions say 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."

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. A deduction for legal fees can reduce the taxpayer's *adjusted* gross income or *taxable* income, but not the taxpayer's *gross* income. It is the latter that is reported on Form 1099.

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* from 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 this in many rulings. And there is some practical precedent too. 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. If you want to read more about the huge topic of Form 1099 reporting, here is a guide for lawsuit settlements.

Consider Taxes and 1099s Before Signing

Plaintiffs should consider taxes and Form 1099 issues before they sign a settlement agreement. A Form 1099 does not prevent you from taking the 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.