

Negotiating Forms 1099 in Settlement Agreements

By Robert W. Wood

Yet 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 IOLTA 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 the tax law.

The best time to raise the question about tax reporting is *before* the settlement agreement is signed. Indeed, 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. 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 settlement agreement says, you can usually get it corrected. There is also the question of which form to use. Many settlement agreements say that a Form 1099 will be issued, but do not say what type of Form 1099, and that can be a mistake.

Form 1099-MISC is appropriate for non-economic damages like emotional distress and punitive damages. These damages are reported in Box 3 of that form as "Other income." On the other hand, Form 1099-NEC reports payments to an independent contractor for services. A Form 1099-NEC may be appropriate if the plaintiff is an independent contractor, and if the payment is compensation for services.

Attorneys also issue Forms 1099-NEC to expert witnesses and other contractors who provided services in the litigation. A Form 1099-NEC tells the IRS the recipient should pay self-employment tax in *addition* to income tax. Since self-employment tax can add up to 15.3% on top of income tax, plaintiffs' receiving taxable recoveries that are *not* a payment for services by an independent contractor may want to specify in the settlement agreement that the payment is to be reported on Form 1099-MISC. Otherwise, a Form 1099-NEC may be issued triggering higher taxes.

In my experience, once a Form 1099 issued, it can be difficult to convince the issuer to correct it, even if you make a good case that the form that was issued is the wrong form. There are hundreds of pages of IRS Form 1099 instructions, and it is often possible for a payor to justify whatever they did. However, if the settlement agreement specifies that the plaintiff will be issued a Form 1099-MISC, and instead a Form 1099-NEC is issued, that should be easy to correct. In that case, the plaintiff can point to the settlement agreement, note that the settlement agreement was breached, and the defendant is likely to correct it. There is an easy Form 1099 correction procedure the payor can follow.

Lawsuit recoveries arising out of employment usually include wages (including severance pay) reported on a Form W-2. But apart from wages, the normal tax reporting for legal settlements is a Form 1099, with 1099-MISC being the most common. Where a recovery includes pre- or post-judgment interest, the interest can often be included on the Form 1099-MISC as part of the "Other income" amount. Some defendants (*e.g.*, banks and financial institutions) may be subject to special reporting rules for interest payments that exceed \$10 per year. For these defendants, interest may be required to be reported separately on a Form 1099-INT.

Many defendants issue a Form 1099 for every settlement when the settlement is made as part of the defendant's trade or business. 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 as a technical matter, only payments of "fixed or determinable gains, profits, and income" should be reported on Form 1099. The IRS says this means the amount that the payor knows to be includable in the recipient's gross income for tax purposes. For example, the regulations under Section 6041 of the tax code provide that "The amount to be reported as paid to a payee is the amount includible in the gross income of the payee (which in many cases will be the gross amount of the payment or payments before fees, commissions, expenses or other amounts owed by the payee to another person have been deducted)[.]" See Treas. Reg. § 1.6041-1(f).

In 2005, the US 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 the plaintiff for a payment that is fully 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 IOLTA account, or having the attorneys' fees paid separately, does not necessarily avoid Form 1099 reporting to the plaintiff. The attorney is the plaintiff's agent in the settlement. Any amounts paid to the attorney on the plaintiff's behalf are treated as *also* paid directly to the plaintiff for Form 1099 purposes.

Plaintiffs with ordinary-income taxable recoveries (including wage payments) must generally find a way to claim a deduction for the fees and expenses. Suppose that a defendant deposits a \$100k gross settlement in plaintiff counsel's IOLTA account. The plaintiff's counsel retains \$40k for contingent fees and expenses, and distributes a \$60k net recovery to the plaintiff. The plaintiff receives a Form 1099-MISC for the full \$100k from the defendant (in Box 3 of that form), even though defendant paid the settlement into the IOLTA account, not directly to the plaintiff. The plaintiff

should include \$100k in gross income, and claim a tax deduction, if possible, for the \$40k in fees retained by their counsel.

The plaintiff counsel should also receive a Form 1099 for \$100k, but the lawyer's Form 1099-MISC should have the funds included in Box 10, not Box 3. Unlike the other boxes on a Form 1099-MISC, Box 10's "Gross proceeds paid to an attorney" is not used by the IRS to audit the attorneys' income tax return. The IRS understands that the amount reported in Box 10 is not necessarily (or often) the same amount as the attorney's fee income.

It is just a payment to an attorney, some of which may or may not be income to the attorney. Therefore, for any recovery paid through the plaintiffs' counsel, the plaintiffs' counsel should expect to receive a Form 1099-MISC reporting the gross amount of the settlement paid to the attorney in Box 10. This is generally harmless to the plaintiffs' attorney, and it is almost never worth fighting over.

The primary area where plaintiffs and defendants argue over Forms 1099 in legal settlements involves physical injury payments. Compensatory payments for physical injuries should not be reported on a Form 1099. The IRS says so in its regulations and in its Form 1099 instructions.

But many defendants expect the tax exclusion to be clear, as in a serious injury case, before they will agree not to issue a Form 1099. In an employment case, if the plaintiff claims physical injuries or physical sickness, it can be a legitimate basis for an exclusion. Even so, some defendants will err on the side of caution and still issue the form.

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