Plaintiffs, Whistleblowers, Legal Fees, and Taxes

by Robert W. Wood

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In this article, Wood examines Form 1099-MISC, "Miscellaneous Information," and Form 1099-NEC, "Nonemployee Compensation," and he explores how income may be reported from litigation settlements and whistleblower awards and how variations in reporting may affect taxpayers.

This discussion is not intended as legal advice.

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Receiving any type of a Form 1099 means you will have to report income and usually pay tax. You may have deductions, but a Form 1099 is presumptively income. Concerns about Forms 1099 arise across many factual settings. I commonly see Form 1099 concerns with litigation settlements, but that is only one context in which these ever-present tax forms are generated.

It is nice to know what tax form you will receive before it arrives in the mail. That is why provisions in settlement agreements optimally say who is going to receive a Form 1099 and for what amount. Specifying exactly what type of Form 1099 and in which box the dollar amount will be displayed is a good idea.

Because legal fees are usually attributed to plaintiffs, Forms 1099 do not always track payments made to lawyers. A plaintiff might receive a net check of $600,000 but is likely to receive a Form 1099 for $1 million if the lawyer is paid $400,000. Plaintiffs that do not expect this may be shocked and upset. How can you be taxed on money you did not receive?

The Supreme Court held in *Banks*[1] that plaintiffs in contingent fee cases must generally recognize gross income equal to 100 percent of their recoveries. This is so even if the lawyer is paid directly and even if the plaintiff receives only a net settlement after legal fees. This harsh tax rule usually means that plaintiffs must figure out a way to deduct their legal fees.[2] Fortunately, that is generally not a problem in whistleblower cases with contingent fee lawyers.

Who Decides Form 1099 Reporting?

For some settlement payments, no Form 1099 is appropriate. It is often a bone of contention in legal settlement agreements, but compensatory payments on account of personal physical injuries or physical sickness should not be reported on Form 1099. Plaintiffs and defendants may not agree about the nature of a payment, but a true physical injury payment is not supposed to result in an IRS Form 1099.

If you are a plaintiff with physical injury or physical sickness claims, this issue is worth fighting for before you sign a settlement agreement. Another rule is less well known, but Forms 1099 are also not generally required for payments of a capital nature, such as those covering damage to your home or compensating you for a fire loss. The payer is unlikely to know

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[1] *Commissioner v. Banks*, 543 U.S. 426 (2005).

[2] *See* Robert W. Wood, "12 Ways to Deduct Legal Fees Under New Tax Laws," *Tax Notes Federal*, Oct. 7, 2019, p. 111; and Wood, "Civil Rights Fee Deduction Cuts Tax on Settlements," *Tax Notes Federal*, Mar. 2, 2020, p. 1481.

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your tax basis in the property or if the payment exceeds it and therefore is not required to issue a Form 1099.

That is true for other capital payments too, even if some of the payment might be ordinary income. If the payer does not know how much of the payment is taxable income, the payer is not required to issue a Form 1099. Disputes among competent tax advisers about the appropriateness and details of Form 1099 are common.

For these and other reasons, negotiating tax language and tax reporting before a settlement agreement is signed can avoid problems later. The default treatment for most legal settlement payments — and most other kinds of payments — is to issue a Form 1099 for any payment of $600 or more. Many business owners believe (incorrectly) that one must issue a Form 1099 to qualify for a business expense deduction.

The wisdom of planning and negotiating tax reporting can apply in other areas too, such as with legal contracts. There may be less flexibility in a contract compared with a legal settlement agreement. But it is still nice to know in advance what type of Form 1099 you will receive and for what amount. Traditionally, the most common version of the series was Form 1099-MISC, "Miscellaneous Information," for miscellaneous income, but to discuss it, we must also talk about the newest one, Form 1099-NEC, "Nonemployee Compensation."

Up until 2020, if you were paying an independent contractor, you reported it on Form 1099-MISC, in box 7, for non-employee compensation. For 2019 and prior years, putting income in box 7 of a Form 1099-MISC tipped off the IRS that this person should not only be paying income tax but self-employment tax, too. Box 3 was for "other income," a more neutral category compared with the old box 7.

Starting in 2020, Form 1099-MISC was changed, and the box 3 or box 7 choice is now gone. Instead, there is a new Form 1099-NEC used to report payments for services. Most litigants and most whistleblowers will receive Form 1099-MISC. But not all. I have seen Form 1099-NEC used for garden-variety settlements that clearly should have been reported on Form 1099-MISC.

Moreover, the SEC has a firm policy of issuing Form 1099-NEC to whistleblowers. They adopted this strange rule a few years before the switch to the new form. The SEC used to report in Box 7 of Form 1099-MISC. Meanwhile, state and federal False Claims Act whistleblowers almost universally receive Form 1099-MISC, Box 3, other income. Perhaps the SEC thinks its whistleblowers perform more personal services than other whistleblowers.

Self-Employment Tax

Self-employment tax equals both halves of the employer and employee payroll taxes that apply to wages reported on Form W-2, "Wage and Tax Statement." Self-employment tax can add a sizable 15.3 percent on top of up to 37 percent in income taxes. That 15.3 percent applies up to the wage base of $147,000, with a 2.9 percent tax thereafter on the excess. There is no limit, even if you earn millions.

The tax code actually imposes three different taxes on an individual's self-employment income. These three taxes include a 12.4 percent Social Security tax, a 2.9 percent Medicare tax, and a 0.9 percent Medicare surcharge tax.[3] For 2022, the Social Security tax applies to an individual's self-employment income up to $147,000.[4] The Medicare tax is imposed on all of an individual's self-employment income (that is, there is no ceiling like with the Social Security tax), and the Medicare surcharge tax is imposed on an individual's self-employment income exceeding, in the case of a joint return, $250,000, or on other returns, $200,000 (that is, the Medicare surcharge floors).[5]

Collectively, these three taxes are commonly referred to as self-employment taxes. For Forms 1099, the MISC versus NEC choice matters, and you may be able to specify (such as in a legal settlement agreement) which will be issued. Otherwise, the payer of the money generally selects the reporting they think is best. It is not uncommon for payers to report on Form 1099-NEC even when they should use Form 1099-MISC. Perhaps the opposite happens too.

[3] Section 1401.

[4] *See* Social Security Administration, "Contribution and Benefit Base."

[5] Section 1401(b)(1), (b)(2).

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Is Being in Business Good or Bad?

Form 1099-NEC is specifically for paying independent contractors. Yet if you ask Form 1099-NEC recipients if they are self-employed, some will say no. The self-employment tax applies to income derived from a trade or business, and whether a taxpayer is engaged in a trade or business can involve muddy factual issues. Sometimes, it is the taxpayer who argues they are conducting a trade or business and the IRS says they are not.

So-called hobby loss cases are the classic example. The taxpayer is attempting to deduct expenses as ordinary and necessary business expenses under section 162 rather than being saddled with the hobby loss rules of section 183. Taxpayers argue that while they are losing money now, they are conducting the activity (horse breeding or race car driving, for example) as a business.

In that context and others, whether activities constitute a trade or business is not straightforward. An amount may be income, but it should only be subject to self-employment tax if the income relates to a real trade or business. Generally, amounts reflected on Form 1099-NEC are reported on Schedule C. If the Schedule C shows a net profit, the net profit is subject to self-employment tax.

In contrast, amounts in box 3 of Form 1099-MISC are generally reported on Schedule 1 of the tax return as "other income." Unlike Schedule C profits, other income is not subject to self-employment tax. The reporting of an amount on either Form 1099-MISC or Form 1099-NEC is based on the payer's views, a payer that in each case is engaged in a trade or business.

The payer's method of reporting influences how the payment should be treated for federal tax purposes in the hands of the payee — but does it always dictate that? Not necessarily. As you might expect, given that the form changed in 2020, there is more law predating Form 1099-NEC. For decades, the IRS's Form 1099-MISC instructions said that a taxpayer should only report box 7 income on Schedule C if the amount represents self-employment income.[6]

Forms 1099 Can Be Wrong

How do you know if you are self-employed? The old Form 1099-MISC instructions advised taxpayers to report box 7 income as "other income" if the payment did not represent self-employment income — such as income from a sporadic activity or hobby.[7] The fact that a taxpayer received a box 7 Form 1099-MISC was not fatal. In fact, in other guidance, the IRS noted that a taxpayer was not required to report box 7 (referring to the Form 1099-MISC before 2020) on Schedule C unless the income was derived from a "self-employed trade or business."[8]

The same theme appears to have been carried over to the new form. The IRS instructions for Form 1099-NEC say "generally," amounts reported in box 1 are subject to self-employment tax. The instructions tell payers that if payments to individuals are not subject to this tax and are not reportable elsewhere on Form 1099-NEC, they should report in box 3 of Form 1099-MISC. In frequently asked questions meant for recipients of the forms, the IRS says:

> Question: I received a Form 1099-NEC instead of a Form W-2. I'm not self-employed and don't have a business. How do I report this income?
>
> Answer: If payment for services you provided is listed on Form 1099-NEC, Nonemployee Compensation, the payer is treating you as a self-employed worker, also referred to as an independent contractor.
>
> You don't necessarily have to have a business for payments for your services to be reported on Form 1099-NEC. You may simply perform services as a non-employee. The payer has determined that

[6] *See* IRS Form 1099-MISC, "Instructions for Recipient." *See also* Wood and Dashiell C. Shapiro, "Blowing the Whistle on Taxing Whistleblower Recoveries," *Tax Notes*, Dec. 2, 2013, p. 983.

[7] Instructions to Form 1099-MISC, *supra* note 6; Wood and Shapiro, "Blowing the Whistle on Taxing Whistleblower Recoveries," *supra* note 6.

[8] IRS Frequently Asked Questions, "1099-MISC, Independent Contractors, and Self-Employed" (last updated Sept. 7, 2022).

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> an employer-employee relationship doesn't exist in your case.
>
> If you weren't an employee of the payer, where you report the income depends on whether your activity is a trade or business. You're in a self-employed trade or business if your primary purpose is to make a profit and your activity is regular and continuous.[9]

In the end, a facts and circumstances test governs whether you must pay self-employment tax. The tax cases have generally held that the facts and circumstances involving the payment (and not which box on the old Form 1099-MISC is used) govern whether the payment is subject to self-employment tax.[10] It does not appear that there are cases litigating the same issue for Form 1099-MISC versus Form 1099-NEC. However, the case law seems likely to remain consistent despite the change in the forms.

Self-Employment Benefits

For a worker doing contractor jobs on the side, self-employment can mean tax deductions for business expenses and tax-deductible retirement contributions. Self-employment means an added tax on net income, but there are plenty of big advantages. What constitutes a business expense can be quite fluid.

If the business is less than successful and brings more tax deductions than income, the business status means extra tax deductions that can hopefully be used to offset other sources of income. One may need to navigate the line between active and passive income, but being self-employed can have big pluses.

Lawsuit and Whistleblower Recoveries

How about lawsuit settlements or recoveries by whistleblowers? In that context, the plaintiff or whistleblower is likely to look at the bottom line. Do they need to be "in business" to write off payments to finders or co-relators? Do they need to be in business to write off legal fees? Difficulty in writing off legal fees was a big issue before 2004 when the above-the-line deduction was added to the tax code.

That law was amended several times since 2004 to expand the deduction, such as including SEC and Commodity Futures Trading Commission claims that were not added until 2018. Yet as a practical matter, the above-the-line deduction for legal fees addresses only contingent fees, when the income and legal fees all hit in the same tax year. What if the plaintiff or whistleblower has paid legal fees hourly, and the legal fees and recovery do not occur in the same tax year?

Schedule C might look attractive if the facts support it. Or what if the plaintiff or whistleblower lives in New Jersey? Amazingly, that outlier state does not appear to have an above-the-line tax deduction for legal fees. As a result, when the point is arguable, treating the activity producing the recovery as a business may be the best way of trying to avoid that odd state tax law rule, albeit with self-employment tax ramifications.

Finally, what if the above-the-line deduction for legal fees does not apply? Civil rights claims qualify, and I argue that this term is a broad one indeed.[11] But for those who do not qualify, is there another path to deduct legal fees? The Tax Cuts and Jobs Act suspended miscellaneous itemized deductions for 2018 through 2025. That put more pressure on the above-the-line deduction, but it can make Schedule C attractive too. In short, even for a plaintiff or whistleblower, receiving a Form 1099-NEC may be good or bad depending on the circumstances. It might nudge you more into trade or business territory even if you don't really belong there.

Conversely, it might put you presumptively into self-employment tax jeopardy when you really are not engaged in a trade or business. The tax cost is nothing to sneeze at. Suppose that you are an unemployed whistleblower and just getting a big payday. Self-employment tax on your wage base of $147,000 could cost you nearly

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[9] *Id.*

[10] *Spiegelman v. Commissioner*, 102 T.C. 394 (1994); *Batok v. Commissioner*, T.C. Memo. 1992-727.

[11] Wood, "Civil Rights Fee Deduction Cuts Tax on Settlements," *Tax Notes Federal*, Mar. 2, 2020, p. 1481.

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$23,000. And 2.9 percent of millions of dollars can add up.

Who Is Self-Employed?

For an individual to be subject to self-employment tax, the income derived from the activity must represent income from a trade or business.[12] For these purposes, the term "trade or business" has the same meaning as it has when used in section 162 (regarding trade or business expenses) and does not include, among other things, an individual's performance of services as an employee.[13] Federal courts and the IRS have examined the facts and circumstances to determine whether a taxpayer is engaged in a trade or business.

For purposes of section 162, courts have considered whether the taxpayer: (1) has been "involved in the activity with continuity and regularity,"[14] (2) devotes "sufficient time over a substantial enough period,"[15] and (3) holds himself or herself out as being "engaged in the selling of goods or services."[16] At least one federal court has held that an individual's activities as a whistleblower can rise to the level of a trade or business.

In *Bagley*,[17] the taxpayer filed a *qui tam* lawsuit against his former employer under the False Claims Act (FCA), and he received a large whistleblower award. The Justice Department issued Richard Bagley a Form 1099-MISC with the FCA whistleblower award reported in box 3 as "other income." Since 2004, there has been an above-the-line deduction for legal fees.

However, during 2003, the year of Bagley's recovery, the tax code permitted only a below-the-line deduction for attorney fees, which were subject to the alternative minimum tax.[18] Bagley reported his award as other income, claiming the attorney fees as a below-the-line deduction. He then amended his return to report the award and attorney fees on Schedule C. The Schedule C idea for deducting legal fees was in vogue before the above-the-line deduction for legal fees was enacted in 2004.

Even employment plaintiffs tried it. "This lawsuit is essentially a trade or business" went the argument, but it usually failed in employment cases.[19] Upon amending his 2003 return, Bagley asked for a big refund, which the IRS denied. Bagley sued and argued that the attorney fees were deductible under section 162 because he had a profit motive and engaged in the activities continually and regularly.

The government said Bagley was not engaged in a trade or business. The court held that Bagley had the requisite profit motive and relied on the regulations under section 183 to distinguish hobby activities from trade or business activities.[20] The regulations provide a list of "relevant factors" in determining whether an activity is engaged in for profit.

The regs caution that "all facts and circumstances with respect to the activity are to be taken into account . . . [and] no one factor is determinative in making this determination." The court concluded that most of the factors favored Bagley, who: (1) spent considerable time on FCA activities, (2) maintained contemporaneous time logs regarding his FCA activities, (3) was an expert in the subject matter of the FCA violations, (4) was not employed during the FCA litigation, and (5) gained no personal recreation or pleasure from the activities.

The court also considered Bagley's attorneys' time and experience, presumably under a theory of agency. Thus, all the time expended by Bagley's attorneys on the FCA lawsuit was attributed to Bagley. Even so, the court reasoned that having a profit motive alone was not sufficient to constitute a trade or business.

Regular and Continuous

The court found that Bagley was also required to show that he devoted "a substantial period of

[12]Section 1402.

[13]Section 1402(c).

[14]*Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987); *see also Green v. Commissioner*, 74 T.C. 1229, 1235 (1980) (taxpayer was "actively engaged" in the "continual and regular process" of selling blood plasma).

[15]*Snyder v. United States*, 674 F.2d 1359, 1364 (10th Cir. 1982).

[16]*Green v. Commissioner*, 83 T.C. 667, 686 (1984).

[17]*Bagley v. United States*, 936 F. Supp. 2d 982 (C.D. Cal. 2013).

[18]Since the TCJA, there is no miscellaneous itemized deduction for legal fees for tax years 2018-2025.

[19]*Alexander v. IRS*, 72 F.3d 938 (1st Cir. 1995).

[20]Reg. section 1.183-2(b).

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time to the activities" or "extensive or repeated activity over a substantial period of time." Relying on the Supreme Court's decision in *Groetzinger*,[21] the court concluded that Bagley needed to show that he engaged in the activity "full time, in good faith, and with regularity" and with a necessary degree of skill applied to the activity.

The court found that Bagley met these requirements. His tasks and responsibilities included: (1) attending regular meetings, (2) reviewing documents, (3) creating and revising court documents, including court filings, (4) preparing damage calculations, and (5) assisting his attorneys and the government in understanding the nature of the FCA claims — in addition to identifying documents and witnesses necessary to effectively litigate the case.

In the typical case, there will always be some element of a profit motive on the part of the plaintiff or whistleblower. But just how regular and continuous it is, what else the person is doing, and how much their counsel is doing will vary materially. It is unclear if all lawyer activities should be attributed to the client.

The time expended varies, too. Plaintiffs and whistleblowers make claims with the hope that they will result in significant recoveries. Some may spend little time on the claim, while others may devote years of full-time work. The possible attribution of the lawyer's time seems worrisome if you are a plaintiff or whistleblower who does not want to be labeled as operating a business. *Bagley* shows that courts may look to the hobby loss regulations.

Whistleblower statutes are geared to reward more active participants with higher percentages. Some programs require whistleblowers to submit statements about their level of participation to assist the government agency in determining the appropriate award. Whistleblowers and their counsel have an incentive to contend that they participated heavily to receive the maximum percentage award. Yet if the whistleblower hopes to avoid self-employment tax, these statements could backfire at tax time.

Conclusion

In the landscape of tax history, Form 1099-NEC is in its infancy. There are likely to be many skirmishes between payers and payees over the form, and many tax disputes between payees and the IRS over whether self-employment tax applies. There are likely to be tax disputes about the deductibility of legal fees too, in which the stakes may be much bigger than self-employment tax.

For reasons that are still not clear to me, SEC whistleblowers are all saddled with Form 1099-NEC. In a large recovery, the whistleblower is likely to care whether they pay self-employment tax on top of income tax. At tax return time, some payees will report the tax and pay it. Some will contend that despite a Form 1099-NEC, they are not self-employed.

Some may ignore the issue altogether, and some payees who did not report self-employment tax are receiving IRS notices. If the amount at stake is small, some people pay it, although (in my experience so far) it may not be difficult to get the IRS to back down. But if the amounts are large, payees may be unlikely to want to pay if they do not have many of the earmarks of a more traditional trade or business. Some of these disputes are likely to end up in court. ■

[21] *Groetzinger*, 480 U.S. 23.

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