Form 1099 Tax Reporting Guide for Lawsuit Settlements

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In this article, Wood and Brown explore the twists and turns of Form 1099 reporting for legal settlements from the perspectives of plaintiffs, defendants, and their counsel.

This discussion is not intended as legal advice.

Forms 1099 feature prominently in lawsuit settlements, often being expressly mentioned in the settlement agreement. Even when they are not mentioned, Forms 1099 conventionally are issued to the plaintiffs, the lawyers, or both. The forms generally report income and are matched to tax returns based on Social Security numbers. When $600 or more is paid in the course of a taxpayer's trade or business for many types of income, the payer must generally issue a Form 1099 to the recipient, with a copy filed with the IRS. There are different versions of the form for different types of income. The most common is Form 1099-MISC, "Miscellaneous Income."

I. Negotiating Forms 1099 in Agreements

Considering the importance of these little forms to the tax treatment of payments, it is surprising that many legal settlement agreements say nothing about whether any tax forms will be issued to the plaintiff or their lawyer. Yet the normal practice for many defendants when a settlement is paid to the plaintiff's lawyer or the lawyer's Interest on Lawyer Trust Account (IOLTA) is to issue a Form 1099 to both the plaintiff and the lawyer, often each for 100 percent. That may sound like double counting, but it is generally required under current tax law.

After a settlement agreement is signed, the plaintiff has no leverage on whether a Form 1099 will be issued, to whom, and for what amount. Therefore, the best time to raise the question about tax reporting is *before* the settlement agreement is signed. Ideally, the parties will agree in the settlement agreement on 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 agreement says, you can get it corrected.

II. Form 1099 Varieties

Form 1099-MISC is appropriate for noneconomic damages like emotional distress and punitive damages. These damages are reported in box 3 of that form as "other income." Form 1099-NEC, "Nonemployee Compensation," may be appropriate if the plaintiff is an independent contractor and 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 that the recipient should pay self-employment tax in addition to income tax. Because self-employment tax can add up to 15.3 percent 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.

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 Form 1099-MISC being the most common. When 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 (for example, banks and financial institutions) may be subject to special reporting rules for interest payments that exceed $10 per year, and for those defendants, interest may have to be reported separately on a Form 1099-INT, "Interest Income."

III. How Much to Report

Many defendants issue a Form 1099 for every settlement that is made as part of the defendant's trade or business. Most do duplicate reporting so that a check payable to the plaintiff and the plaintiff's lawyer will be 100 percent reported to the plaintiff and 100 percent reported to the lawyer. That is what the IRS generally requires for legal settlements. Many defendants think that it is safer from a tax perspective to always send the forms to avoid any doubts about whether they have reporting duties.

However, 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 payer knows to be includable in the recipient's gross income for tax purposes. For example, the regulations under section 6041 provide:

> 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).[1]

In 2005, the Supreme Court decided *Banks*,[2] 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 includable in the plaintiff's gross income must include the gross amount paid, including the amount paid to their lawyer.[3]

Therefore, having the settlement paid to the attorney's IOLTA, or having the attorney fees paid separately, does not necessarily avoid Form 1099 reporting to the plaintiff. The attorney is the plaintiff's agent in the settlement. For Form 1099 purposes, any amounts paid to the attorney on the plaintiff's behalf are treated as also paid directly to the plaintiff.

Plaintiffs with ordinary-income taxable recoveries (including wage payments) must generally find a way to claim a deduction for the fees and expenses.

Example 1. The defendant deposits a $100,000 gross settlement in the IOLTA of the plaintiff's counsel. That counsel retains $40,000 for contingent fees and expenses and distributes a $60,000 net recovery to the plaintiff. The plaintiff receives a Form 1099 (or Form W-2 for wage payment) for the full $100,000 from the defendant, even though the defendant paid into the IOLTA rather than directly to the plaintiff. The plaintiff should include $100,000 in gross income and, if possible, claim a tax deduction for the $40,000 in fees retained by their counsel.

IV. When Do Attorneys Receive Forms 1099?

Form 1099 reporting for legal fees paid applies only to payments made in the course of a payer's trade or business. Therefore, for matters involving nonbusiness clients or nonbusiness disputes,

[1] Reg. section 1.6041-1(f).

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

[3] *See* reg. section 1.6045-5(f), Example 1; and reg. section 1.6041-1(f).

clients generally do not need to issue a Form 1099 to their attorneys for attorney fees paid, regardless of the amount of the fees. Business disputes and business clients are more likely to result in Form 1099 reporting for legal fees paid, typically on a Form 1099-NEC (although some payers may report on a Form 1099-MISC).

Defendants may also issue a Form 1099 to the plaintiff's attorney in connection with a settlement payment. Indeed, all payments paid to an attorney in the course of the payer's trade or business must be reported as "gross proceeds paid to an attorney." This is true regardless of amount and regardless of whether the payment is gross income to the attorney.[4] Even if an attorney is receiving a payment entirely as an agent for their client, with no portion constituting income to the attorney, the attorney is usually supposed to be issued the form. The fact that the payment was made to the attorney in connection with their role as an attorney requires the payment to be reported as gross proceeds paid to an attorney. Gross proceeds reporting is required even if the law firm is a corporation.

One significant exception to this broad rule applies if the payment is required to be reported elsewhere on a Form 1099-MISC, Form 1099-NEC, or Form W-2 under section 6041 or section 6051.[5] Therefore, a business paying its own outside counsel for legal services the business received should report the fees it pays in box 3 of a Form 1099-MISC or on a Form 1099-NEC as required under section 6041, not as "gross proceeds paid to an attorney" under section 6045(f). Similarly, a law firm that is paying its associates their regular salaries and bonuses would report the wages on a Form W2 as required by section 6051, as you might expect wages to be reported, even though the salary payments are technically amounts paid to an attorney "in connection with legal services (whether or not such services are performed for the payor)."[6]

Unlike the other boxes on a Form 1099-MISC, box 10, "gross proceeds paid to an attorney," is not used by the IRS to audit the attorney's income tax return. The IRS understands that the amount reported in box 10 is not necessarily (or often) the same amount as the attorney fee income. Therefore, for any recovery paid through the plaintiff's counsel, that lawyer should expect to receive a Form 1099-MISC reporting the gross amount of the settlement paid to (or through) the attorney in box 10. This is generally harmless to the plaintiff's attorney, and it is almost never worth fighting over.

In Example 1, involving a $100,000 gross taxable recovery and $40,000 of fees and expenses, the lawyer will receive a Form 1099-MISC reporting the full $100,000 as gross proceeds in box 10. Unless the payment to the plaintiff is exempt from Form 1099 reporting, the defendant will also issue a Form 1099-MISC to the plaintiff for the full $100,000, consistent with the *Banks* decision. Because of the "gross proceeds" reporting rules, recoveries often have two Forms 1099 issued, one to the attorney with box 10 reporting and one to the plaintiff (often with box 3 reporting), with each Form 1099 reporting the full amount of the gross recovery.

That may appear like double reporting, but only the plaintiff's Form 1099 is used to assess the gross income of the taxpayer to whom the Form 1099 was issued. The lawyer in the example can report only the $40,000 of legal fees and expenses on their tax returns without worrying about the IRS computer-matching the attorney's tax return to the box 10 amount and triggering an IRS notice. The lawyer does not need to include $100,000 as their gross income and claim a deduction for the payment of the net recovery to the client to try to match the box 10 reporting.

The attorney received the gross recovery only as *agent* for their client, so the client's net portion of the recovery is not includable in the attorney's gross income. If the attorney were to try to match their gross income to the box 10 reporting, it would be inaccurate. It could also make things worse or more complicated for both the attorney and their client.

For the attorney, it would mean trying to substantiate large tax deductions to offset the unnecessarily inflated income. If that substantiation means issuing Forms 1099 to the attorney's client for the distribution of the net recovery to the client, those Forms 1099 could

[4]Section 6045(f).

[5]*See* section 6045(f)(2)(B).

[6]Section 6045(f)(2)(A).

conceivably create Form 1099 penalties for the attorney. Indeed, the defendant is really the payer, and an extra Form 1099 from the lawyer can have significant adverse implications for the client, as discussed below.

V. Should Attorneys Issue Forms 1099 to Clients?

Often, a plaintiff's attorney will receive, on behalf of their client, a gross recovery from the defendant; retain their fees and expenses; and then distribute the net recovery to their client. Should the attorney issue a Form 1099 to their own client for the distribution of the client's net recovery? Almost always, the answer is no. Only the "payer" of a payment is obligated to issue a Form 1099.

In nearly all cases, the defendant is the payer of a settlement payment, even if the defendant delivers the payment to the plaintiff's attorney or pays the settlement into that attorney's IOLTA. The attorney is acting as the plaintiff's agent in receiving the settlement payment, and the attorney is therefore usually not the payer of the settlement for Form 1099 purposes.

VI. Middleman Regulations

The rules on this topic are governed by the so-called middleman regulations found in reg. section 1.6041-1(e). They provide that a middleman becomes a payer for the purposes of Form 1099 reporting only when they "perform management or oversight functions in connection with the payment" and not "mere administrative or ministerial functions such as writing checks at another's directions."

Examples 7 and 8 of the middleman regulations address plaintiffs' attorneys who receive their clients' gross recoveries.[7] Example 7 provides that when an attorney has the power to hire and fire expert witnesses, investigators, co-counsel, and other service providers connected to the litigation, the attorney has "management and oversight functions" regarding the payments made to those persons out of the gross settlement. Therefore, attorneys are generally required to issue a Form 1099 for the payments they make to these contractors out of the gross settlement amount.

Example 8 of the regulations contrasts the payments described in Example 7 with the attorney's distribution of the net recovery to their client. It confirms that an attorney's retention of their fees and expenses out of a gross settlement and their distribution of the net proceeds to their client are merely administrative or ministerial functions and insufficient to cause the attorney to be required to issue a Form 1099 to their client for their net recovery.

Example 2. Suppose, as in Example 1, that we have a $100,000 gross recovery paid into an attorney's IOLTA, with $40,000 in legal fees retained, producing a $60,000 net recovery for the plaintiff. But this time, let's assume that the plaintiff is a business, but not a corporation exempt from Form 1099 reporting, and that the lawsuit was brought in the course of the plaintiff's trade or business. As with Example 1, let's assume that the recovery is fully taxable to the business plaintiff as ordinary business income and specifically as "other income."

In this case, the defendant should report $100,000 in box 10 of a Form 1099-MISC issued to the plaintiff's counsel, as "gross proceeds paid to an attorney." Because the amount is reported in box 10, the IRS computers would likely ignore this Form 1099 in confirming whether the attorney correctly reported their gross income for the year.

Under the Supreme Court's *Banks* principles, the defendant should issue a second Form 1099-MISC to the plaintiff (assuming that the payment is reportable), this time reporting the $100,000 in box 3 as "other income." The IRS computers would likely consider this Form 1099 in assessing whether the plaintiff correctly reported all their gross income from the recovery. Therefore, consistent with the holding in *Banks*, the plaintiff should include all $100,000 in their gross income (to match the Form 1099 amount) and then claim an offsetting $40,000 tax deduction, presumably as a section 162 trade or business expense, for the fees and expenses paid to their counsel.

The legal fees were paid in the course of the *plaintiff's* trade or business, so this plaintiff may be required to issue a Form 1099 to their attorney for the $40,000 of fees and expenses paid. This could help substantiate the $40,000 tax deduction they

[7] *See* reg. section 1.6041-1(e)(5), examples 7 and 8.

are claiming for the fees. This $40,000 payment would likely be reported on a Form 1099-NEC because the fees are compensation for the services of an independent contractor.

Unlike the gross proceeds Form 1099 issued by the defendant, the IRS computers likely would consider this Form 1099 in assessing whether the tax reporting by the plaintiff's counsel included all of the counsel's fee income. This Form 1099 would be only for the actual $40,000 amount of the fees, not for the full $100,000 reported by the defendant as gross proceeds, so it should match the amount the attorney is including in their own gross income.

For fees paid by the plaintiff's counsel to expert witnesses, investigators, referring attorneys, etc., during the same year, that counsel may be required to issue Forms 1099-NEC to the payees to report the fee payments. This can help counsel substantiate any tax deductions they may claim against the $40,000 of fee income in their tax reporting.

The plaintiff's counsel would not need issue a Form 1099 to their client in connection with the distribution of the $60,000 of net proceeds. The plaintiff's counsel is *not* the payer of the settlement payment for tax purposes. And the defendant (the *actual* payer) has already included this amount in the $100,000 Form 1099 it is required to issue to the plaintiff. Not only is it not required for the plaintiff's counsel to issue a Form 1099 to their own client, but it may also be misleading to the IRS if they issue a Form 1099 for $60,000 *that the defendant will also be reporting* as part of its own Form 1099 issued to the plaintiff for the $100,000 gross settlement amount.

This double reporting could suggest to IRS computers that the plaintiff received $160,000 in gross income from the recovery — that is, $100,000 from the defendant and an additional $60,000 from the plaintiff's counsel. In reality, the plaintiff received only $100,000 gross and $60,000 net. No plaintiff who receives a check for $60,000 is likely to be happy — or to know what to do when tax time comes around — if they receive IRS Forms 1099 totaling $160,000.

VII. Plaintiffs Exempt From 1099-MISC Reporting

Some plaintiffs are exempt from being subject to Form 1099 reporting for payments they receive. The most common category is corporations (including S corporations), except for corporations involved in certain industries (medical and legal). Other exclusions can be found in reg. section 1.6041-3.

A. Personal and Nonbusiness Payments

Form 1099-MISC reporting applies only to payments made in the course of a payer's trade or business. Therefore, settlement payments made by defendants who are *not* satisfying a claim related to their trade or business are generally not required to issue a Form 1099 for their settlement payments. However, if payment is made by their insurers, the insurers *may* be subject to Form 1099 reporting obligations because the *insurers* are paying the settlement in the course of their trade or business.

Although the trade or business requirement is often overlooked, it is arguably the exception that most of us typically rely on in our day-to-day lives. In our personal lives, we may regularly pay more than $600 a year to grocery stores, pharmacies, landlords, utilities, insurers, mechanics, schools, retailers, restaurants, food delivery services, airlines, etc. Many of these payments may be otherwise exempt from Form 1099 reporting because they are payments to corporations (that do not provide health or legal services). However, we are spared having to research the corporate organization of these recipients and thus determine whether to issue Forms 1099 because we are not paying them in the course of our trades or businesses. The payments are personal.

B. Payments That Aren't Gross Income to the Recipient

The amount to be reported on a Form 1099-MISC is the amount of a payment that constitutes gross income to the recipient. Therefore, it follows that a payment that is *not* includable in the gross income of the recipient is generally exempt from Form 1099 reporting. Many defendants may not think about this and may simply assume that cash is always income, but that is not always true.

A particularly important example of this exclusion relates to physical injury settlements. A recovery is excludable from the plaintiff's gross income under section 104(a)(2) if it is a payment

for compensatory damages "on account of" a physical injury or physical sickness. Accordingly, to the extent a gross settlement is excludable from the plaintiff's income under section 104(a)(2), it should *not* be reported on a Form 1099.[8] The IRS has also made this clear in the published instructions for Form 1099-MISC and Form 1099-NEC, which state: "Do not report damages (other than punitive damages) . . . [r]eceived on account of personal physical injury or physical sickness."

C. When Payer Doesn't Know How Much Is Gross Income

One odd feature of Form 1099 reporting is that it requires a defendant to ascertain the tax consequences of a payment to the plaintiff. What is a defendant to do if they lack all the necessary information to determine whether and how much of a payment is includable in the recipient's gross income? In practice, many defendants opt to issue a Form 1099 for 100 percent of the payment, thinking that this is the safest approach. But if you are a plaintiff, you may not like this, and the tax authorities suggest it is not required.

A series of private letter rulings issued by the IRS over several decades support the proposition that if the payer does not *know* to what extent a payment is gross income to the recipient, Form 1099 reporting is *not* required. These rulings are discussed below in connection with some specific fact patterns.

1. Capital recoveries.

The fact that most defendants default to issuing a Form 1099 for nearly any payment can be frustrating for plaintiffs. Receiving a Form 1099 does not automatically mean that a payment is conclusively taxable. In appropriate cases, you can explain a Form 1099 on your tax return. However, a Form 1099 puts the recipient at a comparative disadvantage if the payment should not have been issued in the first place.

Forms 1099 are technically not required if the payer does not know how much of a payment is gross income to the recipient. Apart from physical injury damages, the most common context for this to occur is for recoveries that are capital in nature (for example, disputes over sales prices for assets sold or for damage to property). For capital recoveries, the full amount received is *not* gross income to the recipient.

The plaintiff's gross income includes only the gain on the capital recovery.[9] Gain is not the full amount of the payment, but only the amount by which the payment exceeds the taxpayers' adjusted tax basis in the property.[10] If a taxpayer purchased a property for $100, spent $75 improving it, and then sells it for $225, the gross income would be $50 of gain ($225 minus $175). The portion of the $225 that reimburses the seller for their $175 of adjusted tax basis is not a deduction against gross income; it is not gross income at all.

For several years, the Form 1099-MISC instructions have confirmed the foundational point that a payment that is a tax-free recovery of the recipient's adjusted tax basis should not be reported on a Form 1099-MISC. The current version of the instructions for Form 1099-MISC and Form 1099-NEC, as well as the predecessor instructions to Form 1099-MISC stretching back at least a decade, provide that payers should not report damages "that are for a replacement of capital, such as damages paid to a buyer by a contractor who failed to complete construction of a building." To the extent a payment recovers the recipient's adjusted tax basis, it is not gross income to the recipient. Therefore, except for box 10 reporting for lawyers, discussed earlier, only gross income is supposed to be reported on a Form 1099-MISC.

A capital recovery is meaningfully but subtly different from a recovery that is taxed as ordinary income. When a recovery is taxable as ordinary income, the legal fees and expenses that may be paid out of the recovery do not alter the fact that the full amount of the recovery is gross income, as the Form 1099 regulations confirm.[11] The possibility of an offsetting deduction for legal fees or expenses may reduce the taxpayer's *adjusted* gross income or *taxable* income (as those terms are

[8] *See* reg. section 1.6045-5(f), Example 2.

[9] *See* section 61(a)(3).

[10] *See* section 1001(a).

[11] *See* reg. section 1.6041-1(f).

used in the calculation of income tax), but they do not reduce the taxpayer's *gross* income.

It is a taxpayer's gross income that is reported on a Form 1099. Therefore, a defendant can generally be apathetic regarding how much of an ordinary income recovery is owed to the plaintiff's counsel for fees and expenses for Form 1099 reporting purposes. Legal fees and expenses should not affect the amount reportable on the Form 1099 for ordinary income recoveries.

That is not so for capital recoveries. For capital recoveries, a plaintiff's legal fees and expenses are capital expenditures that increase their adjusted tax basis, and they thereby decrease the resulting gain on the recovery.[12] Capitalized legal fees and expenses would reduce the amount that is properly reported on the Form 1099 as gross income to the recipient. Therefore, a defendant *cannot know* how much to accurately report on a Form 1099 in a capital recovery without knowing the plaintiff's adjusted tax basis in the relevant asset, including any adjusted tax basis created by capitalized legal fees and expenses in the litigation.

Consequently, the IRS has issued at least 11 private letter rulings over 38 years stating that when a payer does not know how much of a capital payment is gain (that is, the payer does not know the recipient's adjusted tax basis in their property), Form 1099 reporting is not required or appropriate.[13] Therefore, unless the defendant knows what the exact amount of the plaintiff's legal fees and expenses will be in a capital recovery, the defendant does not know how much of the settlement payment is gross income to the plaintiff.

As a result, for most capital recoveries, the defendant is *not* required to issue a Form 1099-MISC to the plaintiff.[14] Some capital recoveries involving the sale of real estate are to be reported on a Form 1099-S, "Proceeds From Real Estate Transactions." Similarly, defendants who are securities brokers may have to report capital recoveries on a Form 1099-B, "Proceeds From Broker and Barter Exchange Transactions." These forms have different rules, and our discussion concerns only Form 1099-MISC reporting obligations.

For plaintiffs for whom a Form 1099-S or Form 1099-B is required, this is usually less onerous than a Form 1099-MISC and therefore less controversial. Reporting a settlement on a Form 1099-S or Form 1099-B more clearly indicates to the IRS that the settlement is a capital recovery. A Form 1099-MISC is much more likely to imply to the IRS computers that the amount is 100 percent ordinary income.

Of course, even if a Form 1099 is not issued or required, that does not make the payment 100 percent tax free. As discussed throughout this article, a large swath of payments are not subject to Form 1099 reporting (or any other information return reporting), including payments to most corporations and the personal expenses we pay throughout the year. Many or most of those payments are income to the recipient. Similarly, just because we are spared having to issue Forms 1099 for our personal expenses does not mean that the recipients of our payments are spared having to report our payments as required in their own tax returns.

Yet, especially toward the end of a dispute when there may be little goodwill between the opposing parties, the suggestion by a plaintiff that Form 1099 reporting is not required under the relevant tax rules may cause the defendant to believe that the plaintiff is trying to evade a proper tax liability, and that the plaintiff may even be asking the defendant to become complicit. It can be difficult to overcome this kind of presumption, even when a settlement falls squarely within an exception to Form 1099 reporting.

The fact that a plaintiff does not want a Form 1099 to be issued for an excludable physical injury payment, or for a capital payment, does not mean that the plaintiff intends to treat a payment as entirely tax free. In a capital recovery, there is a *portion* of the settlement payment that may be taxable gain. But there is also usually a portion — at minimum, the capitalized legal fees and

[12] *See* sections 263 and 1016(a)(1); reg. section 1.263(a)-1(d) and (e); *Woodward v. Commissioner*, 397 U.S. 572 (1970); *Alexander v. Commissioner*, 72 F.3d 938 (1st Cir. 1995); and *Eisler v. Commissioner*, 59 T.C. 634 (1973).

[13] *See* Rev. Rul. 80-22, 1980-1 C.B. 286; LTR 201810004; LTR 201444001; LTR 200704004; LTR 199945023; LTR 9806008; LTR 9451052; LTR 9437033; LTR 9405010; LTR 9322026; and LTR 9305011.

[14] If the capital recovery is paid to the IOLTA of the plaintiff's attorney, the defendant may nevertheless be required to issue a Form 1099 to that attorney, reporting the settlement in box 10 as "gross proceeds paid to an attorney." *See* section 6045(f).

expenses — that is not gross income to the plaintiff. If not for the parties' heightened suspicion of each other in the context of litigation, it would likely be more understandable to a defendant that a plaintiff would not want a Form 1099 issued to the IRS that incorrectly identifies 100 percent of a settlement payment as being gross income to the plaintiff, if the actual amount of the settlement that is gross income may be significantly less.

Examples of what some defendants have done and are doing in real-life cases can be helpful. For example, in connection with the billions of dollars of legal settlements paid to victims of California wildfires by PG&E and Southern California Edison, both companies (and the related PG&E Bankruptcy and Fire Victims Trust) determined *not* to issue Forms 1099 to fire victims. These defendants issued Forms 1099 to the law firms for the plaintiffs (as gross proceeds paid to an attorney, discussed above), but not to the clients. The companies' correct reasoning was that there might well be *some* ordinary income in every settlement, but there is also property damage, basis recovery, capital gain, etc.

Moreover, even the claims most likely to be ordinary income, such as the claims for noneconomic damages, could involve smoke inhalation and other facts that could allow plaintiffs to exclude some or all of these noncapital allocations.[15] Absent specific identification of what portion of a payment was ordinary income to a wildfire victim and the wildfire victims' adjusted tax bases in their damaged property, both defendants in these vast numbers of settlements concluded that they could not accurately identify the extent that the settlement payments and awards represented gross income to the wildfire victims. That was the proper course of action, despite the billions of dollars paid out.

2. Refunds and tax benefit rule.

A less common situation in which a defendant may not know how much of a payment is gross income involves refunds of payments that the plaintiff previously made. Refunds can often be positioned as tax free. However, if the refund recipient previously claimed a tax deduction for the payment that is now being refunded, and if the previous deduction reduced their income tax liability in that year (or a future year if the deduction created a carryforward that offset income in a subsequent tax year), the refund may be taxable as ordinary income.

The idea is to make up for the tax saved by the prior deduction. This is called the "tax benefit rule," and it has been codified in section 111 of the code. The tax benefit rule is a pragmatic rule to effectively save taxpayers (and the IRS) the inconvenience of having to amend previous years of tax returns to reverse prior deductions as well as any NOLs and other carryforward items the previous deductions may have created. By treating the refund as taxable income in the current year, the tax benefit rule also avoids complexities that would otherwise occur as a result of the statute of limitations.

That is, the previous deduction may have been claimed (or used to offset income) in a prior tax return filed too long ago for the taxpayer to be able to amend it (or for the IRS to audit). The tax benefit rule may sound like a relatively arcane rule that arises only under unusual circumstances. However, many taxpayers experience the tax benefit rule *every* year with their tax reporting.

Indeed, it is the tax benefit rule that causes us to consider whether and to what extent our state and local income tax refunds produce gross income for federal income tax purposes. When you filed your federal return, you may have deducted to the extent possible the full amount withheld and paid to the state for state income tax under the state and local tax deduction.[16] Therefore, if some of the amount that you may have deducted is refunded to you by the state, the tax benefit rule requires you to determine how much of your state tax refund must be treated as gross income for federal income tax purposes.

A key question is just *how much* of a refund is taxable income to the recipient under the tax benefit rule. The IRS has issued at least 17 rulings

[15] *See, e.g.*, LTR 201311006 (ruling that smoke inhalation related to fire was sufficient to constitute a physical injury for the purposes of section 104(a)(2)).

[16] *See* section 164.

or other published guidance over several decades confirming that a payer does not need to determine how much of a refund is taxable to the recipient if the payer does not already know the answer. Instead, the defendant in that case should not issue a Form 1099-MISC when the tax treatment of the refund depends on previous tax details of the recipient that are unknown to the defendant.[17]

The exception to this is a state and local income tax refund. When a state or local government issues a refund, it has a special reporting obligation that does not involve Forms 1099-MISC. Instead, the government entity paying the income tax refund must report it on a special Form 1099 for this purpose — Form 1099-G, "Certain Government Payments."[18] A Form 1099-G, when appropriate, is generally less onerous for the recipient than a Form 1099-MISC. A Form 1099-G clearly identifies that the payment is a state or local tax refund that may not be entirely gross income to the recipient, or that may not be gross income to the recipient in any amount.

In most cases, a Form 1099-MISC is only supposed to report gross income. Unlike a Form 1099-G, if a defendant issued a Form 1099-MISC to a plaintiff for a refund, it would falsely imply that 100 percent of the refund is gross income to the plaintiff. Therefore, plaintiffs are likely to be more insistent on not being issued a Form 1099-MISC when it is not required than they would be about receiving a Form 1099-G.

VIII. Form 1099 Penalties and Exceptions

Most penalties related to Form 1099 for failing to issue a form or for issuing one incorrectly are small, so they create the most serious concerns in situations having numerous payees, such as in a class action. Nevertheless, is it safer for defendants to issue a Form 1099 whenever in doubt? Perhaps, and many defendants think so.

Technically, though, it is important to consider how the relevant penalties are defined in the tax code. The code contains penalties for failing to file a Form 1099 when required: a penalty under section 6721 for the copy of the Form 1099 that should have been filed with the IRS,[19] and a penalty under section 6722 for the copy that should have been provided to the plaintiff.[20] Typically, the IRS imposes only the penalty under section 6721, not both sections, for each failure to file a required Form 1099.

However, a Form 1099 that is not issued to the IRS means that a copy of the Form 1099 was also not provided to the recipient. Therefore, in theory, the IRS could impose penalties under both section 6721 and section 6722 for a failure to issue a required Form 1099. That could mean two penalties, not one, for each violation.

The standard penalties under section 6721 and 6722 are adjusted each year for inflation. For 2024 Forms 1099 that are required to be filed in January 2025, the standard penalty is $330 under each of section 6721 and section 6722.[21]

Therefore, if the IRS were to successfully assert penalties under both sections against a defendant for agreeing not to issue a Form 1099 that the IRS later determined should have been filed, the total penalty the defendant could owe in most cases is $660. In most cases in which the IRS imposed a penalty for failing to file a Form 1099-MISC, the IRS would likely impose only the $330 penalty under section 6721. For 2025 Forms 1099 due to be filed in 2026, the IRS has announced that the inflation-adjusted figure for each penalty will be increased by $10 to $340,[22] thus increasing the total penalty exposure for the defendant under the standard penalty to $680.

No one wants to ignore a law that they think applies, even if the penalties at stake are small. But in questionable cases, it may be comforting that these are relatively small and fixed penalties.

[17] LTR 9322026; LTR 9340007; LTR 9806008; LTR 9853018; LTR 200023052; LTR 200025023; LTR 200106021; LTR 200222001; LTR 200316040; LTR 200519002; LTR 200609014; LTR 200610003; LTR 200704004; LTR 200717013; ITA 199919020; ITA 200032041; ILM 201533012. *Accord* Rev. Rul. 80-22.

[18] *See* section 6050E.

[19] *See* section 6721(a)(2)(A).

[20] *See* section 6722(a)(2)(A).

[21] *See* Rev. Proc. 2023-34, 2023-48 IRB 1287.

[22] *See* Rev. Proc. 2024-40, 2024-45 IRB 1100.

A. Incorrect or Unnecessary Form 1099

The penalties in sections 6721 and 6722 are not limited to failure to file a required Form 1099; the same penalties apply to furnishing *incorrect* Forms 1099.[23] In this context, the IRS's rulings on Form 1099 reporting may be clearer. Since overreporting the amount of a settlement payment that is gross income to a plaintiff is subject to the same penalties as failing to file a Form 1099 *if* a Form 1099 is required, a defendant that *does not know* how much of a payment is gross income to the recipient arguably should not issue a Form 1099.

In short, simply defaulting to reporting 100 percent on the Form 1099 is not a guaranteed way to avoid penalties.

However, it is usually not the small standard Form 1099 penalty about which defendants express the most concern during settlement language negotiations. Instead, defendants may worry about the heightened penalties under both sections that apply to payers who demonstrate "intentional disregard" of their filing obligations.[24]

B. Intentional Disregard Penalty

In instances involving a payer's intentional disregard of Form 1099 rules, the Form 1099 penalties are increased to the greater of $660 *or* 10 percent of the reporting error. This means that for any payment over $6,600, the relevant measure for the intentional disregard penalty is the 10 percent heightened penalty. It is the possibility of a 10 percent intentional disregard penalty that defendants may cite as their reason for refusing to negate the issuance of a Form 1099 in a settlement agreement.

This is especially true for large payments, since 10 percent of a multimillion-dollar settlement creates a *significant* theoretical liability for the defendant. And if the IRS could assess a 10 percent penalty under *both* sections 6721 and 6722, effectively making the penalty 20 percent of the reporting errors, the liability could be even more frightening.

Does this theoretical risk mean that defendants are correct that it is always safer and more appropriate to issue a Form 1099 for the full amount of the settlement payment? Is that true even if they don't know how much of the payment is gross income to the recipient? Is it true even if it is possible or even likely that the payment may qualify for exclusion from the recipient's income?

Different tax advisers may come out differently on these questions, so there is no categorical answer. However, it may be an oversimplification to assume that it is always the safest option for a defendant to insist on issuing a Form 1099 for the full amount, even when the defendant knows that not all of the payment represents gross income to the plaintiff.

The authorities described above and throughout this article repeatedly confirm that it is appropriate for a payer *not* to issue a Form 1099 when the payer does not know how much of the payment is gross income to the recipient. The Treasury regulations also confirm that only the portion of a payment that constitutes gross income to the recipient is supposed to be reported on a Form 1099 under section 6041. Therefore, if a defendant agrees not to issue a Form 1099 in reliance on these authorities, the defendant is not intentionally disregarding their reporting obligations, under even a plain meaning definition of intentional disregard.

In fact, the defendant's decision not to issue a Form 1099 is based on careful regard of these authorities. If a Form 1099 is not required based on IRS-published guidance, there is not a failure to file a required Form 1099. Therefore, even the small standard penalties under sections 6721 and 6722 should not apply, which should obviate the possibility of any *heightened* penalties.

Indeed, the regulations indicate that intentional disregard occurs only when a taxpayer *knows* that Form 1099 reporting is required and nonetheless actively chooses to ignore their reporting obligations. The regulations even provide examples of conduct suggesting a taxpayer has demonstrated willful disregard, including a pattern of "repeatedly failing to file timely or repeatedly failing to include correct information," and failing to

[23] *See* sections 6721(a)(2)(B) and 6722(a)(2)(B).

[24] *See* sections 6721(e) and 6722(e).

correct Form 1099 reporting *after* being notified by the IRS, or when it appears that the taxpayer's choice not to file was based solely on a conclusion that it was cheaper to pay the standard penalty than to pay a reporting agent or tax return preparer to have a Form 1099 prepared.[25]

As these factors indicate, the intentional disregard standard generally requires a deliberate choice to ignore reporting requirements when reporting is clearly required. It therefore does not seem likely that the intentional disregard penalty, as the IRS has defined it, applies to a reporting decision motivated by a good-faith interpretation of the reporting rules, even if that good-faith interpretation ultimately turns out to be incorrect. The tax code is complex, the Form 1099 reporting rules are voluminous, and tax opinions can and do vary.

However, there would seem to be a comfortable amount of breathing room for discussion in many legal settlement reporting decisions. It is hardly willful disregard of the rules when a defendant agrees not to issue a Form 1099 to a plaintiff in a capital recovery in reliance on many IRS private letter rulings confirming that Form 1099 is not required. The situations described in the regulations involving a defendant who *knows* that Form 1099 reporting is clearly required but agrees not to issue the form are quite different.

Perhaps for that reason, we have never seen an intentional disregard Form 1099 penalty collected by the IRS, particularly in a case involving a defendant's decision regarding how to report a legal settlement that involved capital claims, refunds, or physical injury or physical sickness claims. Indeed, we have never seen an intentional disregard penalty *proposed* by the IRS in that context. Considering the large number of legal settlement payments we see every year, that alone seems noteworthy.

The position that it is always safer to report a payment on a Form 1099 appears to rely on the questionable assumption that the intentional disregard penalties under sections 6721 and 6722 can apply *only* to the failure to file a required Form 1099. However, the 10 percent intentional disregard penalties apply to any of the failures described under sections 6721 and 6722. That includes the filing of information returns with incorrect information. In short, overreporting the amount of gross income on a Form 1099 can also be subject to the 10 percent intentional disregard penalty. It may be worth considering which decision by a defendant would give the IRS a stronger factual basis for demonstrating the defendant chose to act with intentional disregard of their reporting obligations.

Plainly, different tax advisers may come out differently on this question. However, reporting 100 percent of a gross payment when the defendant *knows* that only the amount that constitutes gross income is supposed to be reported on a Form 1099 seems like overkill, and it could even draw a stronger inference of intentional disregard than not issuing a Form 1099. After all, the IRS has repeatedly ruled that a payer should not issue a Form 1099 in that situation. A defendant who insists on issuing the form may arguably be choosing to ignore the reporting authorities and to report differently based on an assumption that reporting is always safer, no matter what. If a payment qualifies for an exception to Form 1099 reporting, it should not be reported.

Some tax professionals may assume that the IRS would never impose penalties on overreporting on a Form 1099 because it is an error in the agency's favor, in that it provides more information to the IRS. It also may be perceived to be an inconsequential error, since the plaintiff can always explain the Form 1099 on their tax return. If the IRS audits the recipient based on the Form 1099, the audit should only confirm the amount of tax the plaintiff reported, even though a Form 1099 was issued.

Under this view, which some defendants express, a Form 1099 can only lead to harm to a plaintiff *if* the plaintiff's tax position is later proven to be wrong in a tax audit. In that case, the defendants may say, the only harm the plaintiff experienced is that the plaintiff did not avoid tax they were determined to properly owe, which is no harm at all. Of course, even if the audit completely accepts the plaintiff's tax position, an audit itself can involve professional fees and be stressful. In that sense, a Form 1099 that overreports a plaintiff's gross income and triggers an audit is never without cost to the plaintiff.

[25] *See* reg. section 301.6721-1(f)(3).

Some defendants suggest that a Form 1099 is harmless, but language in the penalty regulations under sections 6721 and 6722 suggests the opposite. The penalty regulations provide that "inconsequential errors or omissions" can be disregarded for penalty purposes.[26] Nevertheless, the penalty regulations provide that errors in monetary amounts reported on a Form 1099 are almost never inconsequential for purposes of the sections 6721 and 6722 penalties.[27] Incorrectly reporting an amount to the IRS as gross income to the plaintiff that is not gross income to the plaintiff is arguably false reporting.

C. De Minimis Errors and Plaintiff Overrides

According to the regulations, the only time an error in the dollar amount reported on a Form 1099 can be disregarded as inconsequential is if the error satisfies the narrow de minimis exception. That means tiny in the context of most legal settlements. The de minimis exception is limited to errors in which the difference between the amount reported and the amount that should have been reported is $100 or less (which is reduced to $25 or less if the amount being reported on the information return is the amount that was withheld for taxes).[28]

Even when the amount reported on a Form 1099 is equal to or within $100 of the amount of the payment that is includable in the gross income of the recipient, the payee (the plaintiff) can choose to file a tax election under sections 6721 and 6722 to override the de minimis exception.[29] If a plaintiff successfully makes an election to override the de minimis election, a defendant's overreporting on a Form 1099 by even a single dollar could be subject to penalties under sections 6721 and 6722. A plaintiff's filing of an override election also likely alerts the IRS to the defendant's reporting error, increasing the chances of the defendant being penalized for their overreporting.

D. Other Penalties

There are other indications in the tax code that Congress does not consider overreporting on a Form 1099 harmless. Section 7434 creates a private cause of action that allows recipients of Forms 1099 to sue the issuers of Forms 1099 in civil court if the Form 1099 issued to them was "fraudulent" and issued "willfully." Very few plaintiffs are likely to go down this road, in our experience, and the costs of pursuing litigation about an errant Form 1099 are part of the issue.

Technically, though, under section 7434, a recipient of a Form 1099 can obtain a judgment from the issuer of a Form 1099 to reimburse the recipient for (1) any legal fees and expenses they had to incur to address the Form 1099 in a tax audit (and any other damages resulting from the fraudulent Form 1099), *and* (2) any legal fees and expenses the recipient had to incur to sue the issuer of the Form 1099 under section 7434 to obtain the reimbursement for their audit expenses and other damages. Of course, it is a high bar for a plaintiff to demonstrate that a defendant's issuance of a Form 1099 that overreports the amount of gross income rises to the level of fraudulent.

Still, it may help to look at a defendant's options in a relative sense. Choosing to report 100 percent of a payment when a defendant knows that not all the amount reported is gross income to the recipient may in some cases arguably be closer to a fraudulent return than not issuing a Form 1099 that Treasury regulations and IRS rulings confirm is not required. As a practical matter, though, it can be a heavy lift indeed for a plaintiff to convince a defendant of these points and to make the defendant comfortable that a Form 1099 in any given circumstance is not required.

Most defendants are businesses paying a settlement in the course of that business. Their tax and accounting staff are going to push for issuing the forms, almost automatically. Intuitively and factually, it is more likely to imagine an IRS penalty for *failing* to issue a form rather than for issuing a form that turns out to be incorrect or unnecessary.

Many, if not most, defendants and their tax advisers may view it as harmless to *always* issue a Form 1099 for a payment, even when it may not be required. This is another reason that it is best to have clear Form 1099 language in a settlement

[26] *See* reg. sections 301.6721-1(c)(1) and 301.6722-1(b)(1).

[27] *See* reg. sections 301.6721-1(c)(2)(iii) and 301.6722-1(b)(2)(i).

[28] *See* reg. sections 301.6721-1(e)(2) and 301.6722-1(d)(2).

[29] *See* reg. sections 301.6721-1(e)(3) and 301.6722-1(d)(3).

agreement. That way, you bargain about it up front, before signing the settlement agreement. Then at least you know in advance what you are going to receive in January.

In some cases, a defendant may ask for tax authorities on point, or for a tax indemnity from the plaintiff or even from the lawyers. Some defendants will even ask for a formal tax opinion on this point. These are all issues to be hashed out as part of the settlement process.

IX. Are Forms 1099 Required for a Deduction?

Despite the authorities discussed above, many defendants issue Forms 1099 for virtually all settlement payments. Some defendants believe that a Form 1099 is required if they want to deduct the settlement payment on their own tax returns. Actually, there is no such requirement.

For example, a business's payment for a slip and fall accident on its premises is deductible, even though a Form 1099 is not required to be sent to the accident victim to the extent the settlement is excludable from the victim's income under section 104(a)(2). If a Form 1099 were required for *any* deduction, most payments to a corporation would also be nondeductible because payments to most corporations are generally exempt from Form 1099 reporting. Although a defendant *should* issue a Form 1099 *when required* to help substantiate that a payment occurred, issuing a Form 1099 is not a prerequisite for claiming or substantiating a tax deduction.

X. IRS Form W-9

Before making a payment, many if not most defendants require an IRS Form W-9 from the plaintiff's law firm *and* from the plaintiff. The defendant may either require it in the settlement agreement or simply ask later, before making any payment. A Form W-9 confirms the plaintiff's taxpayer identification number and other information.

Some plaintiffs are surprised by a Form W-9 request, and they may refuse to provide it. They may think that if the defendant doesn't have their SSN, it will prevent the issuance of a Form 1099. However, if a Form 1099 is required to be issued (which functionally means if the defendant *believes* it is required), the defendant may still issue a Form 1099 with the information they have available (name and address, even if they don't have your SSN or TIN).

Even worse, if a Form 1099 is required to be issued, the defendant is *required* to withhold a percentage (28 percent) of the payment and send it to the IRS as backup withholding if the payee refuses to provide a Form W-9.[30] Ostensibly, the plaintiff should get credit for the withheld amount when they file their tax return reporting the payment. However, because the backup withholding is sent to the IRS and state tax agencies *without* the plaintiff's SSN or TIN, it can be difficult for the plaintiff to get credit for this withholding when they file their tax returns.

In many cases, the agencies will require the plaintiff to provide a Form W-9 to the payer so the payer can issue an updated Form 1099 or Form W-2 (or another form prescribed by the agency) that contains the plaintiff's tax ID and any other missing information. By submitting an updated Form 1099 or other required form with the plaintiff's tax information, the agency can credit the withheld amount to the plaintiff's account.

This leaves plaintiffs who refuse to provide a payer a Form W-9 in an awkward position, even when the plaintiff is correct that the payment is not reportable under the Form 1099 rules. They are generally left with two options to address backup withholding if it occurs, neither of which is appealing. They can return to the defendant later with a completed Form W-9 requesting that the defendant issue a new Form 1099 that contains their tax information. Although government tax agencies prefer this solution, it presumably undercuts the emotional gratification the plaintiff may have felt by refusing to provide the Form W9 in the first place.

Alternatively, the plaintiff can forfeit the funds that were deposited with the government, potentially forever. Because the backup withholding rate is 28 percent for federal purposes, and can be more than that amount once state backup withholding rates are added, backup withholding can represent a significant percentage of the plaintiff's gross recovery. Moreover, it is unlikely that the plaintiff's counsel discounted their fees and expenses by the amount of the

[30] *See* section 3406.

backup withholding, so the funds that were withheld from the recovery for the backup withholding effectively come out of the plaintiff's net recovery after legal fees and expenses in most instances. After legal fees, expenses, and the backup withholding, the plaintiff's net recovery could be a relatively small portion of their gross recovery.

However, a plaintiff does not have unlimited time to claim their backup withholding with the IRS and relevant state tax agencies. Many government tax agencies will retain unclaimed backup withholding for only a certain amount of time for a payee to claim it. If the withheld amount is not successfully claimed by a payee by the end of that period, the government agency may return the deposited funds to the payer who deposited them (the defendant).

Therefore, if a plaintiff refuses or delays returning to the defendant with a completed Form W-9 in time, the plaintiff may end up losing out in two ways. First, they get no credit for the withheld amount against their tax liability, meaning that they would have to pay any tax generated on their gross recovery out of the reduced net recovery they received after legal fees, expenses, and the backup withholding were taken out. Second, the withheld amount may be refunded to the defendant, leaving the plaintiff having to attempt to recover from the defendant again what they had already ostensibly recovered in the litigation.

In addition to these logistical difficulties, plaintiffs who refuse to provide a Form W-9 when requested also face potential tax penalties if the IRS later determines that the defendant was correct that a Form 1099 was required. Section 6723 imposes a $50 penalty for any failure to comply with a "specified information reporting requirement." For the purposes of section 6723, a specified information reporting requirement includes the requirement to provide a Form W-9 when requested in connection with any payment for which Form 1099 reporting is required.[31] Although a potential $50 penalty may pale in impact to the complications and potential consequences of backup withholding, the possibility of a tax penalty and related audit expenses would still be an additional risk and cost that a plaintiff should consider if a Form W-9 is requested by a defendant.

If a plaintiff receives a request for a Form W-9 and believes that the form is not appropriate, the dispute can sometimes be resolved with the defendant. It is better to hammer out an agreement if you can. If you can't, we would rather give them a Form W-9 and receive a Form 1099 to avoid backup withholding. Being subject to backup withholding is usually much worse than receiving a Form 1099.

XI. Correcting a Form 1099

If a defendant issues an erroneous Form 1099, they can file a corrected Form 1099. A Form 1099 cannot be withdrawn entirely, but a corrected form could restate the amount, reporting it as $0, or make any other correction to supersede the originally filed Form 1099 in the IRS's computer system. Sometimes, the IRS still issues a notice based on the original Form 1099, depending on how long it takes the IRS computers to process the corrected Form 1099. However, in these situations, the IRS notice can usually be addressed efficiently if you can provide the IRS with a copy of the corrected Form 1099 in response.

XII. Conclusion

IRS Forms 1099 are among the most important forms in our tax system. They are highly relevant in how a lawsuit recovery will be taxed. As a result, plaintiff attorneys and their clients should be cautious when it comes to Forms 1099 during settlement negotiations. Defendants and their attorneys should also anticipate discussing these rules. Defendants may want to consider whether a knee-jerk reaction to issue a Form 1099 whenever in doubt is always the best policy.

As with any other tax issue related to legal settlements, an optimum time to iron out settlement agreement wording — and tax reporting specifics — is when the parties are still trying to resolve a case. Especially for plaintiffs, the best time to address Form 1099 reporting questions is before the settlement agreement is signed. Otherwise, the plaintiff may have to just do the best they can when tax forms arrive in January. ■

[31] *See* sections 6724(d)(B)(ii) and 6109(a)(2).