

# **SETTLEMENTS & JUDGMENTS:** **Taxability and 1099 Reporting Requirements for Pools**

**AGRIP Spring Conference 2011**

**Gene Sprague | Attorney**  
**BERENBAUM WEINSHIENK PC**  
**370 17th Street | Suite 4800 | Denver CO 80202**  
**Direct 303.592.8327 | Main 303.825.0800**  
**[esprague@bw-legal.com](mailto:esprague@bw-legal.com)**

## I. Introduction

This presentation will consider the taxability of damages; the analysis and guidelines courts and the Internal Revenue Service (“IRS”) use to determine the taxability of amounts paid in the resolution of disputes, whether by judgment or settlement; and associated IRS Form 1099-MISC reporting requirements.

The overarching purpose of the reporting requirements is to manage and shrink the tax gap, or the difference between the tax actually collected and the tax that should be collected.<sup>1</sup> Information reporting is a key part of IRS enforcement efforts.<sup>2</sup> The various versions of Form 1099 enable the IRS to track income that should be reported on individual tax returns.<sup>3</sup> Although the IRS audits only slightly more than one per cent of all individual tax returns, the IRS matches almost all Forms 1099 and Forms W-2 against individual returns. In 2010, the IRS audited 1.58 million returns but sent five million notices to individual taxpayers informing them that income and payment information on file did not match the entries on their tax return and notifying them that additional tax would be due and that penalties and interest might apply. *FY 2010 Enforcement Results*, [http://www.irs.gov/pub/irs-utl/2010\\_enforcement\\_results.pdf](http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf); *Information Reporting Program, Fiscal Year 2009*, <http://www.irs.gov/pub/irs-soi/09db14ir.xls>; *IRS Notice CP 2000 Sample Contents Page 1*, <http://www.irs.gov/individuals/article/0,,id=169287,00.html>.

For the information return matching system to work, the IRS needs businesses to issue the appropriate Form 1099. To induce reporting and enhance revenue, Congress recently increased the penalties for failure to report. *See* Small Business Jobs Act of 2010, P.L. 111-240, §2102, Increase in Informational Return Penalties. IRS data and anecdotal reports indicate that the IRS is conducting more audits for compliance and is getting more aggressive on assessing penalties.<sup>4</sup> The penalties for failure to submit informational returns are summarized below in section III.C.

Appendix A sets forth the IRS’s description of the taxability of damages as contained in *IRS Publication 4345 (Rev. 6-2006)*, <http://www.irs.gov/pub/irs-pdf/p4345.pdf>. Appendix B describes to whom and the number of Form 1099s that must be issued. Appendix C is a copy of the 2011 version of Form

---

<sup>1</sup> The IRS periodically releases estimates of the tax gap. The latest IRS estimate is a gap of about \$350 billion per year. The gap consists of three components: (i) non-filing (taxes not paid by those with a filing requirement who fail to file); (ii) underreporting (taxes underpaid by those who file but underreport what they owe), and (iii) underpayment (taxes not paid by those who fail to remit reported amounts owed when due). *2010 IRPAC Report: The Tax Gap Subgroup*, <http://www.irs.gov/taxpros/article/0,,id=228971,00.html>. Of the three components, underreporting of income tax, employment taxes, and other taxes represent about 80 percent of the tax gap. The single largest subcomponent consists of individuals understating income, taking improper deductions, overstating business expenses, and erroneously claiming credits. Individual underreporting constitutes about half of the tax gap. *Understanding the Tax Gap*, <http://www.irs.gov/newsroom/article/0,,id=137246,00.html>.

<sup>2</sup> “Information reporting is a key component in IRS compliance programs that are designed to detect and pursue noncompliant taxpayers who underreport income, overstate deductions, or fail to file tax returns. IRS seeks to verify compliance by comparing information returns to tax returns to see if taxpayers have filed returns and reported all their income.” *2009 Information Reporting Program Advisory Committee Public Report Letter*, <http://www.irs.gov/taxpros/article/0,,id=214435,00.html>.

<sup>3</sup> There are numerous versions of Form 1099 for the reporting of different types of potentially taxable income – some of the most frequently issued Forms 1099 are: 1099-INT for interest; 1099-DIV for dividends; 1099-G for state and local tax refunds and unemployment benefits; 1099-R for pensions and payments from individual retirement accounts; and 1099-S for real estate transactions. Form 1099-MISC (for miscellaneous income) is the form to be used for reporting, among other types of income, amounts paid after final judgment or in settlement of litigation.

<sup>4</sup> In fiscal year 2010, the IRS collected \$57.6 billion in enforcement revenue, \$8.7 billion more than fiscal year 2009 enforcement revenue. Of the 2010 enforcement revenue, \$4.9 billion came from the information matching system. *FY 2010 Enforcement Results*, [http://www.irs.gov/pub/irs-utl/2010\\_enforcement\\_results.pdf](http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf).

1099-MISC. Appendix D sets forth examples of typical settlement agreement provisions concerning tax matters and tax allocation.

## II. Taxability

For tax purposes, the IRS defines *damages* as an amount received (other than workers' compensation) through prosecution of a legal suit or action or through a settlement agreement entered into in lieu of prosecution). Whether damages should be reported on a Form 1099-MISC requires an understanding of the taxation of damages. For a comprehensive analysis of the tax aspects of settlements and judgments, see: Wood, 522-3<sup>rd</sup> Tax Management, *Tax Aspects of Settlements and Judgments*, BNA 2006, last updated 12/20/2010 (hereinafter, "Wood, 522-3<sup>rd</sup> T.M.").

Damages are taxable and thus subject to informational reporting on Form 1099-MISC if the payment is includable in the recipient's gross income, within the meaning of the Internal Revenue Code ("Code"). As defined in the Code, *gross income* includes "all income from whatever source derived." Code § 61(a), 26 USCS § 61(a); *see also*, *United States v. Burke*, 504 U. S. 229, 233 (1992) (citing *Commissioner v. Glenshaw Glass Company*, 348 U.S. 426, 431 (1955)) (any accession to wealth counts as gross income for purposes of federal income tax, unless Congress has specifically provided an exclusion). From time to time, Congress has created specific exclusions that remove certain types of income from the § 61 definition of gross income. For example, Congress has excluded the following types of income: interest on state and local bonds (Code § 103, 26 USCS § 103), contributions by employer to accident and health plans (Code § 106, 26 USCS § 106), and the exclusion of gain from sale of principal residence (Code § 121, 26 USCS 121). Under these general principles, damages are an "accession to wealth" and will be taxable income unless a specific exclusion applies. As discussed in subsection II.B below, Code § 104, 24 USCS § 104, provides an exclusion for payments received as compensation for physical injuries or physical sickness.

### A. "ORIGIN OF THE CLAIM" TEST:

Courts analyze the federal income tax status of damages through the "*origin of the claim*" test. *U.S. v. Gilmore*, 372 U.S. 39 (1963). Under this rule, the *origin and nature of the underlying claim* that gives rise to the damages must be examined to determine if the damages are excludible from gross income or included within it, and also whether taxable damages are ordinary income or capital gain.<sup>5</sup> *Id.* An amount received in satisfaction of a claim is treated as a substitute for the item of loss or economic detriment alleged in the claim, and therefore the payment will have the same tax treatment as the item itself would have received. If the underlying claim is for lost profits, the judgment or settlement will be for lost profits and the payment will be taxed as ordinary income. If an individual sues for discrimination and seeks back pay, he or she will be taxed as having received wages. If the underlying claim is for damages to a home caused by negligent construction, the claimant's recovery usually will not be income, but rather will be treated as a reduction in the purchase price of the home. If a person sues for physical personal injuries from a car accident or a slip and fall, his or her damages will be excludable from gross income under Code §104(a)(2), even if the judgment or settlement includes compensation for lost wages resulting from an inability to work due to the physical injuries. *See* Wood, 522-3<sup>rd</sup> T. M. at A-5 – A-6; Wood, *10 Things to Know about Taxes on*

---

<sup>5</sup> In addition, the "origin of the claim" also determines whether a defendant paying damages can deduct the damages paid (as a business expense or a capital expense) and whether the damages are currently deductible or must be capitalized. These deductibility issues are irrelevant to a pool that qualifies as a tax-exempt organization.

Damage at <http://www.forbes.com/2010/04/29/tax-legal-damages-employment-injury-personal-finance-robert-wood-4.html>.

For federal income tax purposes, it does not matter whether the payment results from a settlement or a judgment. The same rules apply whether the taxpayer wins a judgment or is paid to settle, even if the dispute never gets past the letter-writing phase. Wood, 522-3<sup>rd</sup> T. M. at A-2 – A-3. However, the payment must be received through prosecution of a suit or in a settlement agreement in lieu of prosecution of a suit. *Id.* at A-3 & C&A-1; *see also* Code § 104(a)(2); 26 C.F.R. § 1.104-1(c). Thus, for example, a general release of claims against an employer under an undisputed termination plan or severance package is not a claim for Code § 104 exclusion purposes; and the amounts paid under such plan or package will be includable in the recipient’s gross income. Program Manager Technical Advice (“PMTA”), 2009-035, Oct. 22, 2008, downloadable via hyperlink at <http://www.irs.gov/foia/article/0,,id=223258,00.html>.<sup>6</sup>

In Revenue Ruling 85-98, the IRS held that the complaint is the most persuasive evidence of the nature of the claims although one can also examine the history of settlement negotiations and the settlement agreement to determine which claims were settled. 1985-2 C.B. 51. In order of preference, it appears that the IRS determines the origin of a claim by examining:

- (1) Any complaint filed (which includes analysis of the nature and character of each of the plaintiff’s original claims);
- (2) The history of negotiations, if the parties have entered into settlement discussions; and
- (3) The settlement agreement, including any allocation of damages agreed to by the parties in the agreement. If the agreement of the parties expressly allocates amounts paid between various claims, the IRS generally will give deference to the allocation so long as:

(a) The agreement was made in an adversarial context and negotiated at arm’s length. *Robinson v. Commissioner*, 102 T.C. 116, 126 (1994) (*aff’d in part rev’d in part*, 70 F.3d (5<sup>th</sup> Cir. 1995), *cert denied* 519 U.S. 824 (1996); and

(b) The terms are consistent with the true substance of the underlying claims. The IRS will not be bound by an allocation in an agreement if other facts and circumstances indicate that the payment was made for a purpose other than the stated purpose. *See Bagley v. Commissioner*, 105 T.C. 396 (1995), *aff’d* 121 F.3d 393 (8<sup>th</sup> Cir. 1997). For example, compensatory damages in the nature of tort-like remedies (e.g., emotional distress) are not available for ADEA claims. PMTA 2009-035; *see also* Wood, 522-3<sup>rd</sup> T.M. at A-88 – A-92.

#### B. NONTAXABLE PERSONAL INJURY CLAIMS:

Once the nature of the claim(s) has been ascertained, both the payer and the recipient should consider whether the claims are taxable or nontaxable. As noted, damages will be taxable unless there are specific Code provisions that make the underlying claims nontaxable. As a general rule, payments received under judgments or settlements that do not involve personal injuries or sickness are includable in taxable income. For claims involving personal injury or sickness, Code §104, 26 USCS §104, excludes:

- amounts received under workmen’s compensation acts as compensation for personal injuries or sickness [§104(a)(1)];

---

<sup>6</sup> PMTAs are legal advice signed by lawyers in the IRS’ National Office of Chief Counsel and issued to IRS personnel. Although PMTAs may not be used or cited as precedent, they provide insight into how the IRS may analyze an issue.

- the amount of any damages (other than punitive damages) received (whether by suit or settlement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness [§104(a)(2)];
- amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness [§ 104(a)(3)]<sup>7</sup>;
- amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from service in the armed forces [§104(a)(4)]; and
- amounts received as disability income for injuries received in a terrorist attack [§104(a)(5)].

To the extent payments received pursuant to a judgment or a settlement are attributable to medical expenses for which a deduction was taken in a prior tax year, the exclusion is not available. Code § 104(a) (first phrase).<sup>8</sup>

Before the enactment of the Small Business Jobs Protection Act of 1996, P.L. 104-188 (“SBJPA”), almost all personal injury recoveries, including emotional distress, libel, slander, malicious prosecution, and other non-physical wrongs were excludible from gross income.<sup>9</sup> As a result of the SBJPA, the exclusion of § 104(a)(2) is now specifically limited to: “*damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.*” (Emphasis added).<sup>10</sup> Thus, damages received for claims based solely on emotional distress are not excludible. Physical symptoms that are mere manifestations of emotional distress for which damages are paid do not result in the damages being treated as paid on account of personal injury unless there is a direct causal link between physical sickness suffered by the taxpayer and any damages paid out to the taxpayer. The legislative history of the SBPJA indicates that physical manifestations of emotional distress, such as insomnia, headaches, and stomach disorders, are not to be treated as physical injuries. HR Rep. No. 737, 104<sup>th</sup> Cong., 2d Sess. 143 n. 56 (1996). Damages received for an emotional injury are excludible, however, to the extent of medical expenses associated with the emotional injury that were not previously deducted. Damages received for actual physical injuries caused by emotional distress (as opposed to mere physical manifestations of emotional distress) are excludible. *See, e.g., Parkinson v. Commissioner*, RIA TC Memo, ¶ 2010-142 (2010) (one half of amount paid in settlement of claims for intentional infliction of emotional distress excludible under §104(a)(2) because payer intended that portion of the settlement to be compensation for taxpayer’s heart attack that was causally linked to her emotional distress; “a heart attack and its physical aftereffects constitute physical injury or sickness rather than mere subjective sensations or symptom of emotional distress; the other half of settlement was not excludible because it was compensation for the emotional distress itself).

<sup>7</sup> Such payments are excludible from gross income only if the premiums for the insurance are paid by the employee. If the premiums are paid by the employer and are not included in the employee’s gross income, such amounts are not excludible. 26 C.F.R. § 1.104-1(d).

<sup>8</sup> § 104(a) – “Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 . . . (relating to medical, etc., expenses) for any prior taxable year, gross income does not include . . . .”

<sup>9</sup> *See, e.g., Roemer v. Commissioner*, 716 F.2d 693 (9<sup>th</sup> Cir. 1983) (defamation is inherently a personal injury, even in a business setting); *Threkeld v. Commissioner*, 87 TC 1294, *aff’d*, 848 F.2d 81 (6<sup>th</sup> Cir. 1988) (excluding damages received in settlement of a suit for malicious prosecution arising out of a business transaction). *But see* Rev. Rul. 85-143, 1985-2 CB 55 (refusing to follow *Roemer*).

<sup>10</sup> Before the 1996 SBJPA amendment, §104(a)(2) only required recoveries to be on account of personal injuries or sickness rather than personal physical injuries or physical sickness.

If a claim has its origin in a physical injury or physical sickness, then all damages – other than punitive damages – resulting from the injury will be treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party.<sup>11</sup> As a result of the 1996 changes to § 104(a)(2), damages for torts such as defamation, malicious prosecution, invasion of privacy, assault (without battery), intentional infliction of emotional distress (without attendant and causally linked physical injury or sickness, and false imprisonment (without an attendant battery) should be fully includible in gross income. Wood, 522-3<sup>rd</sup> T. M. at A-13, A-17 – A-18; *see also* Federal Income Taxation of Individuals, ¶ 7.03, RIA (2009)

Shortly before the 1996 SBPJA amendment to § 104(a)(2), the U.S. Supreme Court established a two-part test for determining whether a recovery of damages for a personal injury is excludible from gross income. First, the underlying cause of action must be based upon tort or tort-type rights. Second, the damages must have been received on account of the personal injuries or sickness. *Commissioner v. Schleier*, 515 U.S. 323 (1995) (decided under the pre-1996 version of §104(a)(2) which did not contain the requirement of “physical injury or physical sickness”). Although decided before the 1996 amendment to §104(a)(2), courts continue to apply the *Schleier* analysis. *See, e.g., Prasil v. Commissioner*, T.C. Memo 2003-100 and *Henderson v. Commissioner*, T.C. Memo 2003-168, *aff’d* 2004 U. S. App. LEXIS 14903 (9<sup>th</sup> Cir. 2004), both applying the two tests set forth in *Schleier* to the current version of §104(a)(2), *i.e.*, under current law (1) a claim must be based on tort or tort-type rights and (2) the taxpayer must show that the damages were received on account of personal physical injuries or physical sickness.

There are thus three primary elements to an analysis of whether damages received on account of personal injury or sickness are excludible from gross income:

*Element (1): Compensatory Damages*

For tax purposes, damages can be divided between compensatory damages and punitive damages. Shortly before the SBPJA amendment to § 104(a)(2), the Supreme Court – reasoning that punitive damages should be taxable because they are designed to punish wrongdoers, rather than to compensate victims – held that punitive damages are not excludible from gross income under the pre-SBPJA §104(a)(2). With one exception, Code § 104(a)(2) currently exempts certain compensatory damages from income but makes all punitive damages taxable. Under the exception, punitive damages received in a personal injury suit are excludible if: (a) the damages are awarded in a civil action which is a wrongful death action and (b) applicable state law (as in effect on September 13, 1995, without regard to any modification after that date) provides or has been interpreted to provide that only punitive damages may be awarded in such an action. Code § 104(c).

*Element (2): Tort or Tort-type Cause of Action:*

In *Schleier* and *U.S. v. Burke*, 504 U.S. 229 (1992), the Supreme Court held that for § 104(a)(2) to apply, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is based upon tort or tort-type rights. The remedies available under statute or common law determine whether the claim is tort or tort-like in nature. *See, e.g., Burke*, 504 U.S. at 234-38 (because the remedies available under Title VI of the Civil Rights Act of 1964 for unlawful discrimination consist of

---

<sup>11</sup> *See, e.g.,* PLR 200121031 (taxpayer can exclude from gross income the entire amount received in settlement of her asbestos claim; her husband contracted physical diseases from exposure to asbestos and the diseases were the proximate cause of the circumstances giving rise to the taxpayer’s loss of consortium, survival, and wrongful death claims).

restoring victims, through back pay awards and injunctive relief, to the wage and employment positions they would have occupied absent the unlawful discrimination, Title VII does not allow awards for compensatory damages, and thus Title VII claims are not tort or tort-type in nature). *See also* Wood, 522-3<sup>rd</sup> T.M. at A-14 – A-15.

In September 2009, the IRS issued proposed regulations intended to conform 26 C.F.R. § 1.104-1(c) to the SBPJA amendments to §104(a)(2). REG-127270-06, 74 Fed. Reg.47152 (9/15/09). The proposed regulations eliminate the requirement that “personal injuries or sickness” be “based upon tort or tort-type rights.” Under the proposed regulations, damages for physical injuries may qualify for §104(a)(2) exclusion even though the injury giving rise to the damages is not defined as a tort under state or common law. The proposed regulations also provide that the section 104(a)(2) exclusion does not depend on the scope of remedies available under state or common law. The proposed change is based on the Treasury Department’s concern that the tort-type rights test of *Burke* could preclude the §104(1)(2) exclusion for damages under a “no-fault” statute that does not provide traditional tort-type remedies. The proposed regulations have not been adopted.<sup>12</sup>

*Element (3): On Account of Physical Injury or Physical Sickness:*

In *Schleier*, the Court – in addition to the requirement that the underlying cause of action must be based on tort or tort-type rights – also imposed the requirement that the taxpayer must show that the damages are received on account of personal injuries or sickness. *Schleier*, 515 U.S. at 336-37. The Court illustrated these two requirements using a hypothetical based on a taxpayer who is in an automobile accident, is injured, and as a result of that injury suffers (a) medical expenses, (b) lost wages, and (c) pain, suffering, and emotional distress that cannot be measured with precision. *Id.* at 329. The example represents a classic tort action. Applying a hypothetical total settlement amount of \$30,000, the Court determined that the entire amount would be excludible under pre-SBPJA §104(a)(2). The medical expenses and the portion of the settlement intended to compensate for pain, suffering, and emotional distress constitute damages “on account of personal injuries.” The Court also stated that the lost wages would be excludible as being “on account of personal injuries” as long as the wages related to the time the employee was out of work due to the injuries. The Court concluded that the critical point of the example is that each component of the settlement is recoverable not solely because the taxpayer received a tort settlement but also because each component of the settlement satisfies the “damages received on account of personal injuries” requirement of pre-SBJPA §104(a)(2). *Id.* at 329-30.

---

<sup>12</sup> If adopted Reg. § 1-104-1(c) would provide:

(c) Damages received on account of personal physical injuries or physical sickness—(1) In general. Section 104(a)(2) excludes from gross income the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness. Emotional distress is not considered a physical injury or physical sickness. However, damages for emotional distress attributable to a physical injury or physical sickness are excluded from income under section 104(a)(2). Section 104(a)(2) also excludes damages not in excess of the amount paid for medical care (described in section 213(d)(1)(A) or (B)) for emotional distress. For purposes of this paragraph (c), the term damages means an amount received (other than workers' compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution.

(2) Cause of action and remedies. The section 104(a)(2) exclusion may apply to damages recovered for a physical personal injury or sickness under a statute, even if that statute does not provide for a broad range of remedies. The injury need not be defined as a tort under state or common law.

The Court then applied its analysis to Mr. Schleier's claims. Schleier was a United Airlines pilot. United, under its established policy, terminated his employment when he turned 60. He then filed suit alleging that his termination violated the Age Discrimination in Employment Act of 1967 ("ADEA"). Relief under ADEA includes judgments compelling employment, reinstatement or promotion, as well as recovery of lost wages. The parties ultimately settled their dispute, and Schleier received \$145,629, one half of which was attributed to back pay. On Schleier's argument that the amount allocated to back pay was excludible, the Court held that even if it viewed his turning 60 or his being discharged on account of his age as the proximate cause of his loss of wages, neither his 60th birthday nor his discharge could be described as a "personal injury or sickness." The Court concluded that although the discharge may have caused psychological injury comparable to the pain, suffering and emotional distress suffered by the hypothetical auto accident victim, no part of Schleier's recovery of back pay was attributable to that injury; the back pay recovery was independent of the existence of any personal injury and, therefore, includible in his gross income. *Id.* See also Wood, 522-3<sup>rd</sup> T.M. at A-15 – A-16.

Code § 104(a)(2) now limits the exclusion to "personal *physical* injuries or *physical* sickness." Although neither Congress nor the IRS has expressly defined the term "physical injuries," the IRS's administrative position is the "bruise rule" – *i.e.*, observable or documented bodily harm, such as bruising, cuts, swelling, or bleeding, is evidence of personal physical injury. If there has been such injury, compensatory damages for consequential emotional distress related to the injury are also excludible from gross income. PMTA 2009-035. See also PLR 200041022 (addressing damages for sexual harassment and assault, both before and after observable bodily harm; damages a taxpayer received that were allocable to unwanted physical contacts prior to an "observable bodily harm" did not constitute "physical injury or sickness" for the purpose of 104(a)(2); however, the IRS noted that direct unwanted or uninvited physical contacts resulting in observable bodily harm such as bruises, cuts, swelling, and bleeding are personal physical injuries); *Stadnyk v. Commissioner*, T.C. Memo 2008-289, *aff'd in unpub. op.*, No. 09-1485 (7<sup>th</sup> Cir. 3/36/10) (emotional distress, humiliation, mental anguish and damage to reputation caused by false imprisonment resulting from a bank erroneously marking a check "nonsufficient funds" are not damages caused by physical injury in the absence of any physical harm; being "physically restrained against her will and subjected to police arrest procedures" was not physical injury because the taxpayer "was not grabbed, jerked around, bruised, or physically harmed as a result of her arrest or detention), *aff'd by order*, 367 Fed. Appx. 586 (6<sup>th</sup> Cir. 2010) (declining to create a *per se* rule that every false imprisonment claim necessarily involves physical injury).

By contrast, injuries received from tort claims for injury to reputation are taxable because they do not involve physical injuries. See, *Oyelola v. Commissioner*, T.C. Sum. Op. 2004-28; *Henderson v. Commissioner, supra*. Other fully-taxable torts that do not involve physical injury or sickness include: intentional infliction of emotional distress and defamation. *Emerson v. Commissioner*, T.C. Memo 2003-82.

In sum, for personal injury or sickness damages to be nontaxable under § 104(a)(2), the amount received must be:

- (1) Compensatory damages;
- (2) The result of the violation of a tort or tort-type right; and
- (3) On account of physical injury or physical sickness.

C. EMPLOYMENT-RELATED CLAIMS:

The legislative history to SBJPA indicates that the primary target of the act was employment litigation. See H. R. Conf. Rep. No. 104-737, 104<sup>th</sup> Cong., 2<sup>nd</sup> Sess., 300 (1996). Prior to the act, it was commonplace for most discrimination and other types of employment recoveries to be allocated to nontaxable emotional distress damages rather than to taxable income. Since Congress amended §104(a)(2) in 1996, almost all employment recoveries are now includible as gross income under Code § 61 and are fully taxable. Examples of these taxable employment-related claims include:

- Severance pay awards, *Abbot v. U.S.*, 76 Fed. Supp.2d 236 (N.D.N.Y. 1999);
- Back-pay awards (if not related to physical injuries as described above), *Rivera v. Baker West*, 430 F.3d. 1253 (9<sup>th</sup> Cir. 2005);
- Awards for gender discrimination, PLR 200303003;
- Awards for age discrimination, *Peaco v. Commissioner*, 48 Fed. Appx. 423 (3<sup>rd</sup> Cir. 2002);
- Awards for wrongful termination, *Tamberella v. Commissioner*, T.C. Memo 2004-47;
- Awards for sexual harassment (if no related physical injuries are present), PLR 200041022;
- Recoveries under the Americans with Disabilities Act, *Johnson v. U.S.*, 76 Fed. Appx. 873 (10<sup>th</sup> Cir. 2003); and
- Recoveries under the Employee Retirement Income Security Act (so long as the original benefits that are being recovered by the suit would not have otherwise been excluded), *Hemelt v. U.S.*, 951 F. Supp. 562 (D. Md. 1996).

D. BUSINESS INJURY CLAIMS:

If claims are based on non-personal injury – *i.e.* claims based on a business injury – they do not fall within Code § 104(a)(2)’s exclusion from income. See 26 C.F.R. § 1.61-14(a). Therefore, the question for non-personal injury damages is whether the award/settlement is taxable as ordinary income or as a capital gain. This tax characterization depends on the “Origin of the Claim” test outlined above.

If a claim creates a recovery that replaces lost profits, it will be taxable as ordinary income. *Longino Est. v. Commissioner*, 32 T.C. 904 (1959). The recovery is only taxable to the extent that the award exceeds the basis of the damaged property. Rev. Rul. 55-264.

If a claim creates a recovery that compensates for damage to a capital asset, then the recovery is taxable as capital gain. Rev. Rul. 74-251. An example of this sort of recovery would be a recovery for environmental damage that has reduced the value of a piece of real estate held as a capital asset. FSA 200228005. Again the award becomes taxable only after it exceeds the basis of the capital asset that was damaged.

In sum, non-personal injury claims generate taxable income to the extent that they compensate the plaintiff beyond whatever basis the plaintiff had in the damaged property. If the underlying claim would

have generated ordinary income, the award will be taxed as ordinary income. If the underlying claim would have generated a capital gain, the award will generate a capital gain.

E. INTEREST:

Interest on damages is always taxable. Attempts to re-characterize interest as “delay damages” have not been successful; the IRS has ruled such awards to be the equivalent of interest. *See, Francisco v. U.S.*, 267 F.3d 303 (3<sup>rd</sup> Cir. 2001); *Aames v. Commissioner*, 94 T.C. 189 (1990).

In the 10<sup>th</sup> Circuit, the taxability of prejudgment interest has been firmly established, even in tort cases that would be otherwise tax-free under § 104(a)(2). *Brabson v. United States*, 73 F.3d 1040, 1047 (10<sup>th</sup> Cir. 1996). When the allocation between prejudgment interest and the tort award have not been expressly allocated, courts may impose an allocation if it is reasonably clear how much of the ultimate award is attributable to interest. *See, Rozpad v. Commissioner*, 154 F.3d 1 (1<sup>st</sup> Cir. 1998).

Postjudgment interest is taxable. TAM 199922056. The more important question is determining in which tax year the postjudgment interest accrues. The IRS has ruled that postjudgment interest accrues in the year that the judgment became final and may not be appealed further. *Id.*

F. ATTORNEY FEES:

The amount to be reported on Form 1099-MISC as paid to a claimant is the total amount includible in claimant’s gross income, which in many cases will be the gross amount before attorney fees, whether paid hourly or on a contingent fee basis, are deducted. If the claim is fully nontaxable (*e.g.*, an auto accident with physical injuries and a resultant loss of income), the recovery of fees will not be includible in gross income. However, if the claim is taxable (*e.g.*, suit for intentional infliction of emotional distress or an employment-related claim), the recovered fees will be includible in the claimant’s gross income and reportable on Form 1099 MISC as part of the Box 3, *Other income*. *See* 26 C.F.R. § 1.6041-1(f)(1) and 26 C.F.R. § 1.6045-5(f), Examples 1 and 2.

The case law on this issue is not settled. In *Commissioner v. Banks*, 543 U.S. 426, 430 (2005), the Supreme Court held that as a general rule, “when a litigant’s recovery constitutes income, the litigant’s income includes the portion of the recovery paid to the attorney as a contingent fee.” Because the Court announced its holding as a “general rule,” it implicitly endorsed the notion that there will be exceptions. *Wood*, 522-3<sup>rd</sup> T.M. at A-58 – A-60. Nonetheless, the IRS takes the position that taxpayers must include contingent fees in income. The IRS also asserts that generally fees awarded to a prevailing plaintiff under federal and state fee-shifting statutes belong to the plaintiff and not the attorney and constitute gross income to the plaintiff. PMTA 2009-035.

F. CONCLUSION:

In summary, compensatory damages are taxable unless there is a specific exclusion such as Code § 104(a)(2) for physical injuries or physical sickness. Where the taxpayer suffers a physical injury, all damages flowing from the injury are excludible from gross income. Emotional distress is not considered a physical injury or physical sickness. However, damages for emotional distress attributable to a physical injury or physical sickness are excluded from income under section 104(a)(2). Section 104(a)(2) also excludes damages not in excess of the amount paid for medical care (described in section 213(d)(1)(A) or (B)) for emotional distress. Almost all employment recoveries are includible as gross income and are fully taxable. Except where state law provides that punitive damages are the only damages that may be recovered

in a wrongful death action, punitive damages are taxable. Interest on damages is always taxable. If the claim gives rise to taxable damages, recovered attorney fees, whether paid hourly or on a contingent fee basis, will be includible in the recipient's gross income.

### III. 1099-MISC Reporting

#### A. PAYMENTS PRIOR TO JANUARY 1, 2012:

Code § 6041(a), provides:

All persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and **income . . . , of \$600 or more** in any taxable year, . . . shall render a true and accurate return to the [IRS], under such regulations and in such form and manner and to such extent as may be prescribed by the [IRS], setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

26 U.S.C. § 6041(a) (emphasis added).

Pursuant to § 6041, the Secretary of the Treasury has adopted prescribed forms for information returns, including Form 1099 MISC. 26 C.F.R. § 1.6041-1. The 2011 version of 1099 MISC is attached as Appendix C. With certain exceptions not applicable to public entity insurance pools ("Pool"), the regulations require that:

[E]very **person engaged in a trade or business shall make an information return** for each calendar year **with respect to payments it makes** during the calendar year in the course of its trade or business to another person *of* fixed or determinable income described in paragraph (a)(1)(i) (A) [*i.e., salaries, wages, commissions, fees, and other forms of compensation for services* rendered aggregating \$600 or more] *or* (B) [interest, rents, royalties, annuities, pensions, and other gains, profits, and **income aggregating \$600 or more**].

26 C.F.R. § 1.6041-1(a)(1) (emphasis added).

However, the issuance of a Form 1099 does not necessarily establish tax liability, as that determination is made by the IRS. *Ward v. American Fam. Life Assur. Co. of Columbus*, 444 F. Supp. 2d 540, 544, fn. 6 (D.S.C. 2006). Although the burden shifts from the taxpayer to the IRS when a taxpayer asserts a reasonable dispute regarding income reported on a Form 1099 filed by a third party and seeks to have it amended, ultimately the taxpayer seeking to exclude money damages from income bears the burden of proving that an exclusion applies. *Rivera v. Baker West, Inc.*, 430 F. 3d 1253, 1256 (9<sup>th</sup> 2005).

#### *PUBLIC ENTITY INSURANCE POOLS ARE ENGAGED IN A TRADE OR BUSINESS FOR 1099 REPORTING PURPOSES*

The term *all persons engaged in a trade or business* as used in Code § 6041(a) [26 U.S.C. § 6041(a)], includes not only those so engaged for gain or profit, but also organizations the activities of which are not for the purpose of gain or profit. Thus, the term includes organizations referred to in Code §§ 501(c) and (d) [26 U.S.C. §§ 501(c) and (c)]. Accordingly, a Pool is currently required to issue a Form 1099 MISC to:

- (a) persons, other than corporations (except as noted below), receiving payments aggregating \$600 or more for services provided to the Pool, and
- (b) persons receiving payments aggregating \$600 or more for taxable damages.

*PAYMENTS FOR WHICH NO FORM 1099 IS REQUIRED*

The regulations provide that information returns are not required for certain types of payments including, for example, payments of income required to be reported on IRS Form W-2 or payments of bills for merchandise, telegrams, telephone, freight, storage, and similar charges. 26 C.F.R. § 1-6041-3 (a) and (c). The regulations also provide that payments made to certain *persons* are not required to be reported, including payments to the United States or to a state, the District of Columbia, a possession of the United States, or any political subdivision or instrumentality of any of the foregoing; an organization exempt from taxation under Code § 501(a) [26 U.S.C. § 501(a)]; or a corporation (except as noted below). 26 C.F.R. § 1-6041-3 (p).<sup>13</sup>

With respect to corporations, the regulations state that payments to a corporation need not be reported, except with respect to payments made after December 31, 1997 for attorney's fees, and except a corporation engaged in providing medical and health care services or engaged in the billing and collecting of payments in respect to the providing of medical and health care services. However, no reporting is required where payment is made to a hospital or extended care facility that is exempt from taxation under Code § 501(a) or to a hospital or extended care facility owned and operated by the United States, a state, the District of Columbia, a possession of the United States, or a political subdivision, agency, or instrumentality of any of the foregoing. See 26 C.F.R. § 1-6041-3 (p)(1). Because most Pool members are political subdivisions, agencies, or instrumentalities, payments to members do not have to be reported. However, payments to a member's employees or former employees, will have to be reported in most circumstances.

For the purposes of the regulations, the term *corporation* includes a partnership all of whose members are corporations, but only if the partnership files with the pool a certificate stating that each member of the partnership is a corporation. Absent actual knowledge otherwise, a Pool may treat a payee as a corporation if one of the following requirements is met before a payment is made:

- (1) the name of the payee contains an unambiguous expression of corporate status, *i.e.*, *Incorporated, Inc., Corporation, Corp., Professional Corporation, P.C.* (but not *Company* or *Co.* which are often used to by partnerships or sole proprietorships and not *LLC* – limited liability company, *LP* – limited partnership, *LLP* – limited liability partnership, or *LLLP* – limited liability limited partnership) or contains the term *insurance company, indemnity company, reinsurance company, or assurance company*;
- (2) the Pool has on file a corporate resolution or similar document clearly indicating corporate status;
- (3) the Pool receives an IRS Form W-9 which includes and EIN and a statement from the payee that it is a domestic corporation; or
- (4) the Pool receives a withholding certificate that includes a certification that the person whose name is on the certificate is a foreign corporation.

---

<sup>13</sup> Where not otherwise provided in the Code, the term *person* is defined under Code § 7701(a)(1) as including a corporation. Prior to the enactment of the Patient Protection and Affordable Care Act (“PPAC”), P. L. 111-148, Code § 6401 did not contain a definition of *person*. As discussed in section III.B., the PPAC amended §6401 to provide, for payments made after December 31, 2011, that the term *person* includes any corporation that is not an organization exempt from tax under Code § 501(a). Code § 6041(i).

See 26 C.F.R. § 1.6049-4(c)(ii)(A)(1) to (4).

*A POOL MAY BE REQUIRED TO REPORT JUDGMENT OR SETTLEMENT PAYMENTS TO BOTH THE PLAINTIFF AND THE PLAINTIFF'S ATTORNEY*

Current IRS regulations provide:

[A] person who, in the course of a trade or business, pays \$600 of taxable damages to a claimant by paying that amount to the claimant's attorney is required to file an information return under section 6041 [26 U.S.C. § 6041] with respect to the claimant, **as well as another return** under section 6045(f) [26 U.S.C. § 6045(f)] with respect to the claimant's attorney.

26 C.F.R. § 6041-1(a)(1)(iii) (emphasis added). Code § 6045(f) requires the reporting of "any payment to an attorney in connection with legal services (whether or not such services are performed for the payor)." As noted, the reporting exception for payments made to a corporation does not apply to payments for attorney fees made after December 31, 1997.

Whether a Pool must issue a Form 1099 to the plaintiff only, to the attorney only, or to both the plaintiff and the attorney depends on the specific circumstances of payment. The Pool's issuing requirements will differ depending on whether a Pool pays the judgment or settlement with a check made out to the plaintiff only, a check made out to the attorney only, a check made out to plaintiff and the attorney, separate checks made out to plaintiff and attorney, a check made out to multiple attorneys, or using another method of payment such as wire transfer. An explanation of a Pool's issuing requirements for each of these situations is set forth in attached Appendix B.

**B. PAYMENTS AFTER DECEMBER 31, 2011:**

The Patient Protection and Affordable Care Act ("PPAC), P. L. 111-148, contains provisions that, unless repealed or amended, will impact 1099 MISC reporting requirements for Pools. Except for payments to corporations, the PPAC does not change the principles or rules regarding (a) the taxability of damages or (b) the description of to whom and the number of Forms 1099 that must be issued in connection with a damages judgment or settlement. However, beginning on January 1, 2011, the PPAC, unless those provisions are repealed or amended, will impose new and additional reporting requirement on Pools with respect to payments made in the ordinary course of their general, day-to-day business operations.

*1099 MISC REPORTING FOR PAYMENTS TO CORPORATIONS*

As a result of the PPAC, 1099 reporting requirements for **payments made after December 31, 2011** will be expanded. First, payments to corporations will no longer be exempt automatically from reporting requirements by virtue of the payee's corporate status. PPCA provides that beginning in 2012, notwithstanding any IRS regulation issued before March 23, 2010, the term *person*, for information reporting purposes, will include any corporation that is not exempt from tax under IRC § 501(a). See PPCA, § 9006 of P.L. 111-148, adding a new subsection (i) to Code § 6401 providing, for payments made after December 31, 2011, that: "[n]otwithstanding any regulation prescribed by the Secretary [of the Treasury] before the date of enactment of this subsection, for purposes of this section the term 'person' includes any corporation that is not an organization exempt from tax under section 501(a)." Code § 6041(i). Thus, unless PPCA is amended, § 6041(i), will effectively supersede the current regulations, and payments to corporations will no longer automatically be exempt from 1099 reporting after December 31, 2011, unless the corporation is a tax-exempt entity.

## AMOUNTS PAID IN CONSIDERATION OF PROPERTY AND OTHER GROSS PROCEEDS

Second, the types of payments that will trigger reporting will include amounts paid in consideration of property and other gross proceeds. Code § 6041(a) specifies a list of payments that can trigger 1099 reporting. For payments made before January 1, 2012, these include “rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinative gains, profits, and income.” If the aggregate amount of these payments to a single payee equals \$600 or more, then § 6041(a) obligates the payer to report the amount of those payments and the identity of the payee.

For payments made after December 31, 2011, PPCA amends this list to include *amounts in consideration of property* and other gross proceeds. P.L. 111-148, § 9006(b).<sup>14</sup> Currently, payments for merchandise, telegrams, telephone, freight and storage are exempt under IRS regulations. *See* 26 C.F.R. § 1.6401-3(c). However, those payments may be considered amounts in consideration for property or gross proceeds under Code § 6041(a) and could be subject to reporting when the amended language goes into effect. Because the terms *amounts in consideration for property* and *gross proceeds* are not defined in the PPCA or elsewhere in the Code, *property* may be given a broad definition and probably will include computer equipment, software, office supplies, raw materials, and just about anything else you can put your hands on. What the term *gross proceeds* is intended to include is not clear. Some commentators suggest that it is intended to cover payments to non-corporate payees such as restaurants and other small businesses.

### C. PROCEDURES AND PENALTIES:

The deadline for filing information returns after December 31, 2011 will be the same as the current deadlines – *i.e.*, February 28 of the year following the calendar year in which the payments were made, or March 31 if filed electronically. However, copies of information returns must be provided to payees no later than January 31 of the year following the calendar year in which the payments were made. As is presently the case, after December 31, 2011, information returns will have to identify the payer accurately and the payee as well as the total amount paid. Payees will still be required to provide their names, addresses, and taxpayer ID numbers to payers. It will continue to be the payer’s obligation to request information from the payee, and the payee will be required to provide it.<sup>15</sup> The payer may use IRS Form W-9 to request the information. If the payee does not provide a TIN, the payer generally is required to withhold 28% from all subsequent payments due to the payee. A payee is subject to a penalty of \$50.00 for each failure to provide the correct TIN to a payer.

Both the failure to submit an accurate information return to the IRS and the failure to provide a copy of the return (*i.e.*, the appropriate 1099 form) are subject to monetary penalties. As a specific return is required for each payee, penalties are assessed on each deficient return. Under the recently enacted Small Business Jobs Act of 2010, P.L. 111-240, §2102, the following penalties for failure to file a required Form 1099 will be in effect for **tax year 2011:**

---

<sup>14</sup> As amended, the pertinent language of §6041(a) would read: “rent, salaries, wages, **amounts in consideration for property**, premiums, annuities, compensations, remunerations, emoluments, or other **gross proceeds**, fixed or determinable gains, profits, and income.” (Emphasis added).

<sup>15</sup> Code §6041(c) requires the recipient to provide both name and address upon demand by the payer. IRC § 6109(a)(1) requires the payer to report the TIN of the payee. Code § 6109(a)(2) requires the payee to provide the TIN to the payer.

- Penalty for filing a Form 1099 not more than 30 days late increases from \$15 to \$30, with a maximum of \$250,000;
- Penalty for filing a Form 1099 more than 30 days late and before August 1 increases from \$30 to \$60, with a maximum of \$500,000;
- Penalty for filing a Form 1099 on or after August 1 increases from \$50 to \$100, with a maximum of \$1,500,000; and
- Penalty for intentional failure to file increases from \$100 to \$250, with no maximum.

For a good general discussion of the impact of PPCA on 1099 reporting requirements, see *Form 1099 Information Reporting Requirements as Modified by the Patient Protection and Affordable Care Act*, Congressional Research Service (August 6, 2010), [http://www.pppnet.org/pdf/crs\\_1099.pdf](http://www.pppnet.org/pdf/crs_1099.pdf).

#### **IV. Examples of Language to Address Tax Matters or Tax Allocation in Settlement Agreements**

Settlement agreements often include provisions to address tax matters and any tax allocation or characterization agreed upon between the parties. Examples of such provisions are set forth in Appendix D.

# Appendix A

## Text of IRS Publication 4345

The Internal Revenue Service recognizes that receiving a settlement award (amount) from a personal injury suit may create new tax issues for some individuals. The following information is provided to assist recipients of cash settlements.

The type of settlement you receive is determined by your Final Settlement Agreement.

### **Physical injuries or physical sickness settlements are generally non-taxable.**

- If you receive a settlement for physical injuries or physical sickness and did not take an itemized deduction for medical expenses related to this injury in prior years, the full amount is non-taxable and generally does not need to be reported on your income tax return.  
BUT
- If you receive a settlement for physical injuries or physical sickness and did deduct medical expenses related to the injury, the tax benefit amount is taxable and should be reported as “Other Income” on line 21 of Form 1040.

### **Interest, punitive damages, emotional distress or mental anguish, and employment discrimination or injury to reputation settlements are generally taxable.**

- Interest: Amounts on any settlement are taxable as “Interest Income” and should be reported on line 8a of Form 1040.
- Punitive Damages: Amounts are taxable and should be reported as “Other Income” on line 21 of Form 1040. It does not matter if punitive damages are related to a physical injury or physical sickness.
- Emotional distress or mental anguish: Amounts are taxable to the extent that they exceed medical costs, not previously deducted, for treatment of emotional distress or mental anguish. A statement showing the entire settlement amount less related medical costs should be attached to the return. The net taxable amount should be reported as “Other Income” on line 21 of Form 1040.
- Employment discrimination or injury to reputation: Amounts are taxable and should be reported as “Other Income” on line 21 of Form 1040.

### **Loss-of-use or loss-in-value of property settlements may be taxable if the settlement exceeds your basis in the property.**

- Property settlements that are less than the adjusted basis of your property are not taxable and generally do not need to be reported on your tax return.
- When property settlements exceed your adjusted basis in the property, the excess is gain. Gains on personal capital assets are reported on Form 1040’s Schedule D, Capital Gains and Losses. Gains on business capital assets are reported on Form 4797, Sale of Business Property.

Some settlement recipients may need to make estimated tax payments if they expect their tax to be \$1,000 or more after subtracting credits & withholding. Information on estimated taxes can be found in IRS Publication 505, Tax Withholding and Estimated Tax, and in Form 1040-ES, Estimated Tax for Individuals.

## APPENDIX B

### 1099 Issuing Requirements

#### A check made out only to Plaintiff:

If some or all of a judgment or settlement payment is includible in Plaintiff's gross income and the Pool writes a check payable to Plaintiff only, the Pool is required to provide Plaintiff only with a 1099. The amount paid would be reported on Form 1099-MISC in Box 3, *Other income*. If the settlement check is delivered to the Plaintiff's attorney, the key question is whether or not the attorney has the right to negotiate the check. **Fn. 1** If Attorney is not listed as a payee on the check and does not have the right to negotiate the check, the Pool is not required to provide the Attorney with a 1099. **Fn. 2** It is important to note that if Attorney's client trust account is listed as a payee on the check, the check is not considered to be made out only to Plaintiff, and the Pool will be required to provide a form 1099 to Attorney as well as Plaintiff. **Fn. 3**

If the Plaintiff refuses to provide a TIN or EIN, the Pool would withhold 28% of that amount and report the withholding in Box 4, *Federal income tax withheld*.

Remember that the amount to be reported as paid to Plaintiff is the amount includible in Plaintiff's gross income, which in many cases will be the gross amount before attorney fees are deducted. If the Plaintiff's claim is fully nontaxable (*e.g.*, an auto accident with physical injuries and a resultant loss of income), the fees will not be includible in Plaintiff's gross income. However, if the claim is taxable (*e.g.*, suit for intentional infliction of emotional distress or an employment-related claim), the recovered fees will be includible in Plaintiff's gross income and reportable on Form 1099 MISC in Box 3, *Other income*. See 26 C.F.R. § 1.6041-1(f)(1) and 26 C.F.R. § 1.6045-5(f), Examples 1 and 2.

#### FOOTNOTES

1. 26 C.F.R. § 1.6045-5(d)(4) ("Payment by check to an attorney means a check on which the attorney is named as a sole, joint, or alternative payee. The attorney is the payee on a check written to the attorney's client trust fund. However, the attorney is not a payee when the attorney's name is included on the payee line as 'in care of,' such as a check written to 'client c/o attorney,' or if the attorney's name is included on the check in any other manner that does not give the attorney the right to negotiate the check.")

2. *Id.*

3. *Id.*

If the check is made payable to Plaintiff only, but the check is delivered to Attorney because it is addressed to Plaintiff "in care of "or "c/o" Attorney, the Pool is not required to provide a form 1099 to Attorney, but is required to provide a form 1099 to Plaintiff. **Fn. 4**

## FOOTNOTES

**4.** 26 C.F.R. § 1.6045-5, Example 4. ("Check made payable to claimant, but delivered to non-payee attorney. Corporation P is a defendant in a suit for damages in which C, the plaintiff, has been represented by attorney A throughout the proceeding. P settles the suit for \$ 300,000. Pursuant to a request by A, P writes the \$300,000 settlement check payable solely to C and delivers it to A at A's office. P is not required to file an information return under paragraph (a)(1) of this section with respect to A, because there is no payment to an attorney within the meaning of paragraph (d)(4) of this section.")

### **A check made out only to Attorney:**

If some or all of the judgment or settlement payment is includible in Plaintiff's gross income, and the check is made payable to only Attorney, the Pool is required to provide a form 1099 to both Attorney and Plaintiff. **Fn. 5** This is because the Pool has separate obligations under the Code to provide Attorney and Plaintiff with Forms 1099. **Fn. 6** 26 C.F.R. § 1.6045-5 states that the Pool must provide Attorney with a Form 1099 for payments over \$600 whether or not the attorney's services were performed for the Pool and whether or not the Pool is required to provide additional Forms 1099. **Fn. 7** 26 C.F.R. § 1.6041-1 states that the Pool is also required to provide Plaintiff with a Form 1099 for payments made over \$ 600 if the payment is considered gross income to Plaintiff. **Fn. 8** Therefore, when a check is made out to Attorney only and the payment is considered gross income to Plaintiff, the Pool is required to provide Forms 1099 to Attorney and Plaintiff.

Plaintiffs' attorneys often tell defendants or their insurers to issue one check payable to the plaintiff's attorney or the attorney's trust account and assert that this payment arrangement avoids both withholding and the necessity for 1099 reporting. This practice may not create tax or reporting issues in personal injury cases where the injury is a physical injury or sickness. In such a case, the recovery would be excludible from gross income under § 104(a)(2). Indeed, in cases of personal physical injury or physical sickness, the payer should not report damages other than punitive damages. See Instructions for Form 1099 MISC (2011) at p. 4 (Re: Box 3: "[D]o not report damages (other than punitive damages): a. Received on account of personal physical injuries or physical sickness; b. that do not exceed the amount paid for medical care or emotional distress."). However, in almost any other type of litigation (*e.g.*, employment-related cases), the practice is contrary to the Code §§ 6041 and 6045 and related regulations at 26. C.F. R. §§ 1.6041-1 and 1.6045-5. With regard to withholding obligations in employment-related cases, a defendant's issuance of a settlement check to a plaintiff's attorney is not likely to obviate the employer's withholding obligation. See Wood, *Can Settlement Checks Obviate Withholding and Form 1099*, Vol 128, No. 12, Tax Notes, (September 20, 2010), p. 1285.

## FOOTNOTES

**5.** Code § 6045(f); 26 C.F.R. § 1.6041-1(a)(1)(i); 26 C.F.R. § 1.6045-5(a)(1); 26 C.F.R. § 1.6045-5(a)(1)(ii).

**6.** Defendant is required to provide individuals and businesses with a 1099- MISC under Code § 6041 and 26 C.F.R. § 1.6041-1. Defendant is required to provide Attorney with a 1099-MISC under Code § 6045 and 26 C.F.R. § 1.6045-5 regardless of whether or not Defendant has provided 1099s to any one else representing the same payment.

7. 26 C.F.R. § 1.6045-5 (“every payor engaged in a trade or business who, in the course of that trade or business, makes payments aggregating \$600 or more during a calendar year to an attorney in connection with legal services (whether or not the services are performed for the payor) must file an information return for such payments. . . The requirements of this paragraph (a)(1) apply whether or not-- (i) A portion of a payment is kept by the attorney as compensation for legal services rendered; or (ii) Other information returns are required with respect to some or all of a payment under other provisions of the Internal Revenue Code and the regulations thereunder.”)

8. 26 C.F.R. § 1.6041-1 (“every person engaged in a trade or business shall make an information return for each calendar year with respect to payments it makes during the calendar year in the course of its trade or business to another person of fixed or determinable income.”)

**A check made out to Attorney and Plaintiff:**

If some or all of the judgment or settlement payment is includable in Plaintiff's gross income and the check is made payable to both Attorney and Plaintiff, the Pool is required to provide Forms 1099 to both Attorney and Plaintiff. This is because the Pool has separate obligations under the Code and Treas. Regs. to provide Attorney and Plaintiff with Form 1099. **Fn. 9** Additionally, a check made payable to Attorney's client trust account is considered to be made payable to Attorney. **Fn. 10** Therefore, if a check is made payable to both Attorney's client trust account and Plaintiff, the Pool will be required to provide 1099s to both Attorney and Plaintiff. **Fn. 11**

**FOOTNOTES**

9. Code § 6041 and 26 C.F.R. § 1.6041-1 require Defendant to provide individuals and businesses with Forms 1099; Code § 6045 and 26 C.F.R. § 1.6045-5 require Defendant to provide Attorney with Forms 1099 even when other 1099s have been issued. Specifically, 26 C.F.R. § 1.6045-5 provides that the requirement to issue a form 1099 to attorney applies "whether or not . . . (ii) Other information returns are required with respect to some or all of a payment under other provisions of the Internal Revenue Code and the regulations thereunder." 26 C.F.R. § 1.6041-1(a)(1)(iii) explains that for payments made after January 1, 2007, "a person who, in the course of a trade or business, pays \$600 of taxable damages to a claimant by paying that amount to the claimant's attorney is required to file an information return under section 6041 with respect to the claimant, as well as another information return under section 6045(f) with respect to the claimant's attorney."

10. 26 C.F.R. § 1.6045-5(d) ("The attorney is the payee on a check written to the attorney's client trust fund.")

11. 26 C.F.R. § 1.6045-5, Example 1 ("One check--joint payees--taxable to claimant. Employee C, who sues

employer P for back wages, is represented by attorney A. P settles the suit for \$300,000. The \$300,000 represents taxable wages to C under existing legal principles. P writes a settlement check payable jointly to C and A in the amount of \$200,000, net of income and FICA tax withholding with respect to C. P delivers the check to A. A retains \$100,000 of the payment as compensation for legal services and disburses the remaining \$100,000 to C. P must file an information return with respect to A for \$200,000 under paragraph (a)(1) of this section [and report the amount on 1099-MISC in Box 14, *Gross proceeds paid to an attorney*]. P also must file an information return with respect to C under Code §§ 6041 and 6051, in the amount of \$300,000 [and report the amount in Box 3, *Other income*].")

### **Separate checks to Attorney and Plaintiff:**

If separate checks are made out to Attorney and to Plaintiff that are payable to Attorney and to Plaintiff respectively, the Pool is required to provide Attorney with a Form 1099-MISC in the amount of the check made out to Attorney and provide Plaintiff with a Form 1099-MISC for the total amount of the judgment or settlement payment that is includable in Plaintiff's gross income (including the payment to Attorney). **Fn. 12** Therefore, if a judgment or settlement is entered against Defendant for \$300,000, and Attorney and Plaintiff request that Defendant provide Attorney with a check payable to Attorney only for \$100,000 for Attorney's fees and provide Plaintiff with a check payable to Plaintiff only for \$ 200,000, the Pool must provide Attorney with a 1099-MISC showing the amount of \$100,000 in Box 7, *Nonemployee compensation*, and provide Plaintiff with a 1099-MISC showing the amount of \$300,000 in Box 3, *Other income*. **Fn. 13**

### **FOOTNOTES**

**12.** 26 C.F.R. § 1.6041-1(a) ("every person engaged in a trade or business shall make an information return for each calendar year with respect to payments it makes during the calendar year in the course of its trade or business to another person of fixed or determinable income. . . (f) Amount to be reported when fees, expenses or commissions are deducted (1) In general. 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), whether the payment is made jointly or separately to the payee and another person.")

**13.** 26 C.F.R. § 1.6045-5 Example 3 ("Separate checks--taxable to claimant. C, an individual plaintiff in a suit for lost profits against corporation P, is represented by attorney A. P settles the suit for \$300,000, all of which will be includible in C's gross income. A requests P to write two checks, one payable to A in the amount of \$100,000 as compensation for legal services and the other payable to C in the amount of \$200,000.

P writes the checks in accordance with A's instructions and delivers both checks to A. P must file an information return with respect to A for \$100,000 under paragraph (a)(1) of this section. Pursuant to § 1.6041-1(a) and (f), P must file an information return with respect to C for the \$300,000.")

**A check made out to multiple Attorneys:**

If multiple attorneys are listed as payees on the check, the Pool must provide a Form 1099 MISC to the payee attorney to which the check is delivered. **Fn. 14** If multiple attorneys are listed as payees on the check, but the check is delivered to someone who is not a payee, the Pool must provide a 1099-MISC to the first named payee Attorney on the check. **Fn. 15**

**FOOTNOTES**

**14.** 26 C.F.R. § 1.6045-5(b)(1)(i)(b) ("Special rules--(1) Joint or multiple payees--(i) Check delivered to one payee attorney. If more than one attorney is listed as a payee on a check, an information return must be filed under paragraph (a)(1) of this section with respect to the payee attorney to whom the check is delivered.")

**15.** 26 C.F.R. § 1.6045-5(b)(1)(iii) ("Check delivered to non-payee. If two or more attorneys are listed as payees on a check, but the check is delivered to a person who is not a payee on the check, an information return must be filed under paragraph (a)(1) of this section with respect to the first-listed payee attorney on the check.")

**Another method of payment such as cash, wire transfer or electronic transfer:**

The rules regarding Form 1099 apply to all settlement or judgment payments including payments made with cash, wire transfer, electronic transfer or any other form of payment. **Fn. 16** Payments made by alternative methods should be treated as if they were made by check and rules discussed above apply.

**FOOTNOTE**

**16.** 26 C.F.R. § 1.6045-5(d)(4) ("Payments to an attorney include payments by check or other method such as cash, wire or electronic transfer.")

# APPENDIX C

## Form 1099-MISC 2011

VOID     CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1 Rents \$	2 Royalties \$	3 Other Income \$	4 Federal income tax withheld \$	OMB No. 1545-0115  <b>2011</b>  Form 1099-MISC	<b>Miscellaneous Income</b>		
		5 Fishing boat proceeds \$	6 Medical and health care payments \$	<b>Copy 1 For State Tax Department</b>					
		7 Nonemployee compensation \$	8 Substitute payments in lieu of dividends or interest \$						
PAYER'S federal identification number	RECIPIENT'S identification number	9 Payer made direct sales of \$5,000 or more of consumer products to a buyer (recipient) for resale <input type="checkbox"/>		10 Crop insurance proceeds \$					
RECIPIENT'S name  Street address (including apt. no.)  City, state, and ZIP code		11	12	13 Excess golden parachute payments \$		14 Gross proceeds paid to an attorney \$			
Account number (see instructions)		15a Section 409A deferrals \$		15b Section 409A Income \$		16 State tax withheld \$		17 State/Payer's state no.	18 State Income \$
								\$	\$

Form 1099-MISC Department of the Treasury - Internal Revenue Service

## APPENDIX D

### Examples of Tax Matters and Tax Allocation Language

Settlement agreements should include language to address tax matters:

A typical provision provides as follows:

**Tax Matters:** [Plaintiffs)], jointly and severally, acknowledge and agree that (a) neither [Defendants], nor any or their insurers, agents, representatives or attorneys have made any statements, representations, or warranties regarding the state or federal tax treatment or consequences of the payment(s) provided for in this agreement, (b) [Plaintiffs] shall be solely responsible and liable for how they report, characterize, allocate, or treat such payments for tax purposes, and (c) [Plaintiffs] shall each be responsible and liable for the payment of all state and federal taxes, if any, which may be due as a result of their receipt of such payments or any portion thereof. [Plaintiffs] shall hold [Defendants] and their insurer(s), agents, representatives and attorneys harmless and indemnify them for any tax liabilities, interest, or penalties relating in any way to the tax treatment of the payments made pursuant to this agreement.

**Note:** If the agreement contains a confidentiality provision and the parties have not agreed upon tax allocation or characterization, the confidentiality provision either should expressly allow for the filing of an IRS Form 1099 (*e.g.*, “Plaintiffs acknowledge and agree that nothing contained in this confidentiality provision shall be interpreted or applied so as to preclude [Defendant] or its insurer(s) from filing an IRS Form 1099 information return.”) or more generally provide that it does not prohibit disclosure to the extent legally required (*e.g.*, “This confidentiality provision does not prohibit disclosures by [Defendant] or its insurer(s) to the extent otherwise legally required by law including, but not limited to, state or federal tax laws or regulations.”).

The parties to a settlement may negotiate and agree upon the characterization and allocation of the settlement payment(s) for tax purposes. An example of tax allocation/characterization language follows;

**Tax Allocation and 1099 Reporting:** In consideration for [Plaintiff’s] entering into this agreement, [Defendant] shall pay the following amounts as specified below, the adequacy of which is hereby acknowledged, in full and final settlement of all matters settled and released hereby.

(a) \$\_\_\_\_\_ by a check payable solely to [Plaintiff], such amount representing payment to [Plaintiff] on account of [Plaintiff’s] wage-related claims, less all appropriate income and employment tax withholding, such amount to be the subject of an IRS Form W-2 issued to [Plaintiff].

(b) \$\_\_\_\_\_ by a check payable solely to [Plaintiff], such amount representing payment to [Plaintiff] on account of [Plaintiff’s] claims for personal physical sickness, personal physical injuries, and emotional distress arising from such sickness/injuries, together with medical expenses (other than medical expenses that are attributable to (and not in excess of) deductions allowed under § 213 of the Internal Revenue Code for any prior taxable year). The parties understand that a payment for such a claim is excludable from [Plaintiff’s] gross income under § 104 of the Internal Revenue Code. As a result, the parties understand that filing IRS Form 1099 with respect to a payment for such a claim is neither necessary nor appropriate under the current statute and regulations.

(c) \$\_\_\_\_\_ by a check payable solely to [Attorney] on account of attorneys’ fees and costs. Such amount shall be subject of an IRS Form 1099 issued solely to [Attorney].

(d) The parties acknowledge and agree that the foregoing allocation and manner of payment represents a good faith allocation and agreement between the parties dealing at arm’s length. The parties agree

to report consistently and treat such payments in accordance with such allocation for all tax purposes.

(e) If there is a change in the Internal Revenue Code, U.S. Treasury Regulations, instructions to IRS Forms or other applicable IRS authority that requires, as of the time the IRS Forms reporting these payments are due to be filed, reporting to the IRS in a manner different from that set forth above, [Defendant] and/or its insurer(s) will report to the IRS in compliance with the changed reporting requirements.

(f) [Plaintiff] will be solely responsible for remitting to federal and/or state tax authorities any applicable taxes due with respect to the payments made pursuant to sub-paragraphs (a) to (c) above. [Plaintiff] shall hold [Defendant] and its insurer(s), agents, representatives and attorneys harmless and indemnify them for any tax liabilities, interest, or penalties relating in any way to the tax treatment of the payments made pursuant to this agreement.