



**LITIGATION RECOVERIES
AND INCOME TAX
CONSEQUENCES:
1099 Reporting and
Withholding Requirements
for Legal Aid Services and
Their Clients**

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1099 Reporting and Withholding Requirements in General

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 Secretary, under such regulations and in such form and manner and to such extent as may be prescribed by the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such Payment.

IRC §6041(a)

1099 Reporting and Withholding Requirements in General

The "1099" is the prescribed information form businesses are required to file with the IRS to comply with their reporting requirements. Treas. Reg. §1.6041-1(a)(2).

There are multiple 1099's and various uses thereof depending on the circumstances. Some of the common 1099's your clients are likely to encounter include:

- 1099-A
- 1099-B
- 1099-C
- 1099-S
- 1099-MISC

What is Income?

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

- (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
- (2) Gross income derived from business;
- (3) Gains derived from dealings in property;
- (4) Interest;
- (5) Rents;
- (6) Royalties;
- (7) Dividends;
- (8) Alimony and separate maintenance payments;
- (9) Annuities;
- (10) Income from life insurance and endowment contracts;
- (11) Pensions;
- (12) Income from discharge of indebtedness;
- (13) Distributive share of partnership gross income;
- (14) Income in respect of a decedent; and
- (15) Income from an interest in an estate or trust.

IRC §61



What is Income?

Thus "income" is extremely broad. Any economic gain, i.e., an accession to wealth, should be treated as income unless specifically exempted under the Code.



Awards and Prizes

(a) **General rule**
Except as otherwise provided in this section or in section 117 (relating to qualified scholarships), gross income includes amounts received as prizes and awards.

IRC §74

Thus, initially assume an award or prize as a litigation recovery is gross income unless an exception applies.

Moreover, the regulations state that:

Amounts paid as prizes and awards that are required to be included in gross income ... when paid in the course of a trade or business are required to be reported in returns of information ...

Treas. Reg. §1.6041-1(d)(3)

Instructions to Form 1099-MISC say to "enter in box 3 prizes and awards that are not for services performed."



Awards and Prizes

But a litigation award could represent many things. Two fundamental types of awards and prizes exist:

- a. Wage Compensation
- b. Non-Wage Damages



a. Wage Award

If a litigation award represents compensation for wages in some way, it is subject to withholding and employment taxes. See IRC §3402.

- ▶ “Wages” are defined as “all remuneration ... for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash...”

IRC §3401(a)



a. Wage Awards

- ▶ Back Pay – most find that back wages are wages for services rendered, and subject to withholding and employment taxes. See *Social Security Board v. Nierotko*, 327 U.S. 358 (1946).

- ▶ Front Pay – not all courts find that front pay, i.e., payment for services not yet rendered, are wages subject to withholding and employment taxes.

This dichotomy is in a current state of flux, and the IRS is in the process of looking at the issue.



b. Nonwage Damages

That part of a litigation award that does not represent wages (e.g., punitive damages, emotional suffering, etc.) may or may not be taxable to your client.

As a result, they may or may not require a 1099.

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Award and Prize Exception

The principle exception to the taxation of an award or prize is IRC §104:

... gross income does not include ... (2) 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 ...

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Punitive Damages

Thus as a general rule punitive damages would be included in your client's gross income and would require a 1099-MISC.

Exception to the Exception - §104(c):

The phrase "(other than punitive damages)" shall not apply to punitive damages awarded in a civil action—

- (1) which is a wrongful death action, and
(2) with respect to which applicable State law (as in effect on September 13, 1995 and without regard to any modification after such date) provides, or has been construed to provide by a court of competent jurisdiction pursuant to a decision issued on or before September 13, 1995, that only punitive damages may be awarded in such an action.

This subsection shall cease to apply to any civil action filed on or after the first date on which the applicable State law ceases to provide (or is no longer construed to provide) the treatment described in paragraph (2).

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Cancellation of Debt

A debt is any amount owed to another, including principal, interest, fees, penalties, etc. When a debt is canceled, that amount is considered income because the borrower has been unjustly enriched due to the discharged obligation to repay the debt.

Cancellation of debt is reported on Form 1099-C, NOT 1099-MISC.

There are many exclusions to the tax consequences of cancellation of debt income; however, it will still be reported on Form 1099-C.

Unlike a 1099-MISC, the instructions to 1099-C specifically state that:

Form 1099-C must be filed regardless of whether the debtor is required to report the debt as income.



Cancellation of Debt Exclusions

Although not an exception to the reporting requirements, there are exclusions to the taxation of discharged debt.

The typical exclusions where discharge of debt is not included in gross income include:

1. The discharge occurred in a Title 11 case (bankruptcy).
2. The taxpayer was insolvent immediately before the discharge.
3. The debt was "qualified farm indebtedness."
4. The debt was "qualified real property business indebtedness," or
5. The debt was "qualified principle residence indebtedness."

IRC §108(a)(1)



Insolvency

If, immediately before the debt was cancelled, your client's total liabilities exceed the fair market value of their assets, the canceled debt income is not included in their gross income to the extent they are insolvent.

- ▶ To report the exclusion, your client should usually file Form 982 with their federal income tax return.



Insolvency

Example 1

- ▶ Your client is released from an obligation to pay a debt of \$5,000. Their financial situation is as follows immediately before the \$5,000 debt is canceled:

Assets: \$7,000 Liabilities: \$15,000

- ▶ Thus your client is insolvent to the extent of \$8,000 (\$15,000 - \$7,000).
- ▶ Your client would not have to include in their gross income the \$5,000 canceled debt.

Insolvency

Example 2

- ▶ Similar situation, in that your client is relieved of an obligation to pay \$5,000. However, their financial situation immediately before the cancellation is as follows:

Assets: \$7,000 Liabilities: \$10,000

- ▶ Thus your client is insolvent to the extent of \$3,000 (\$10,000 - \$7,000). Accordingly, \$3,000 of the \$5,000 discharged debt can be excluded from your client's gross income.

Qualified Principal Residence Indebtedness

If the debt is "qualified principle residence indebtedness" (e.g., home mortgage), your client may be able to exclude some, or all of the canceled debt.

- ▶ Generally, a debt is qualified principle residence indebtedness if it is incurred to buy, build, or substantially improve your client's main home. It does include a refinance if incurred to buy, build, or substantially improve the main home, to the extent of the first mortgage principle balance before refinancing. The discharge cannot be a result of services performed for the lender or any other factor not directly related to a decline in the home's value or financial condition of the taxpayer.
- ▶ A principle residence is generally a home that your client owned and used as their principle place of residence for 2 years or more in a 5 year period leading up to the discharge.
- ▶ The limit is generally \$2,000,000 (\$1,000,000 for married filing joint clients).

Attorneys Fees

Attorney fees paid as a component of a litigation recovery may be taxable and require a 1099.

Two theories exist:

1. Payment of Liability
2. Anticipatory Assignment of Income

Attorneys Fees as Income

▶ **Payment of Liability**

▶ Under this theory, your client is contractually obligated to you (by expressed retainer agreement or implied) for their fees. When the litigation concludes, they are indebted to you, and the payment of that obligation (i.e., a discharged debt) by the other party creates an economic gain for your client.

▶ See *Old Colony Trust Co. v. CIR*, 279 U.S. 716 (1929).

▶ **Anticipatory Assignment of Income**

▶ Under this more modern theory, the total recovery thought of as an economic gain to your client, and they cannot assign that income to you in an attempt to avoid taxation.

▶ See *CIR v. Banks*, 543 U.S. 426 (2005).

Suffice it to say, it is well established that attorney fees are taxable income to your client

▶ However, they may be able to deduct certain attorneys fees, but that is beyond the scope of this presentation.

Attorney Fees as Income

Exception – PLR 135328-09

▶ This involved a case where the client had no expressed or implied obligation to pay attorneys fees.

▶ No contingency fee existed because the client has expressly agreed to a pro bono fee arrangement

□ As a result, there can be no anticipatory assignment of income

▶ No legal fees were sought on behalf of the client as part of the litigation

□ As a result, there was no payment of liability doctrine.

2. How Will it Be Paid?

We've addressed what the litigation recovery represents, but how it is paid out will impact the reporting of it.

Three basic scenarios exist:

- 1. Payment directly to the client
- 2. Payment to you (the attorney)
- 3. Payment from you (the attorney)

Paid Directly to Client

If the recovery is included in your client's gross income under the principles above, the amount is over \$600, and the other side is operated for gain or profit and the payment is made in the course of that trade or business, the opposition will likely file an appropriate 1099.

Paid Directly to Client

Example

- ▶ You are successful in a breach of contract action, and the defendant must pay your client \$140,000.
- ▶ Of that \$140,000, \$100,000 represents damages and \$40,000 represents attorney fees.
- ▶ The defendant must issue a 1099-MISC to your client reporting \$140,000 as other income because it is included in their gross income.

This rule holds true even if two checks (i.e., \$100,000 to your client and \$40,000 directly to you) are written, as discussed infra.

Treas. Reg. §1.6041-2(f)(2)

Paid to You (attorney)

Special rules exist for the reporting of recoveries paid to attorneys.

Any person engaged in a trade or business and making a payment (in the course of such trade or business) to which this subsection applies shall file a return ... with respect to such payment.

(2) Application of subsection

(A) In general This subsection shall apply to any payment to an attorney in connection with legal services (whether or not such services are performed for the payor).

(B) Exception This subsection shall not apply to the portion of any payment which is required to be reported under section 6041(a) (or would be so required but for the dollar limitation contained therein) or section 6051.

IRC §6045(f)



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Paid to You (attorney)

If applicable, payments to you as an attorney are reported on 1099-MISC, box 14. The instructions to that form state that:

Under section 6045(f), report in box 14 payments to an attorney made in the course of your trade or business in connection with legal services, for example, as in a settlement agreement, unless the attorney's fees are reportable by you in box 7... These rules apply whether or not the legal services are provided to the payer and whether or not the attorney is exclusive payee (for example, the attorney's and claimant's names are on one check) or other information returns are required for some or all of a payment under section 6041A(a)(1). For example, a person who, in the course of a trade or business, pays \$600 of taxable damages to a claimant by paying that amount to a claimant's attorney is required to furnish Form 1099-MISC to the claimant under section 6041 and furnish Form 1099-MISC to the claimant's attorney under section 6045(f).



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Paid to You (attorney)

Exceptions – some payments may not qualify or be exempt from this requirement:

- o Payment to attorney acting as trustee in Title II bankruptcy case.
- o Payments not giving attorney right to negotiate the check
- o Having the check made payable to "client c/o attorney" would not make the attorney the sole, joint, or alternative payee and no 1099-MISC would be required. Treas. Reg. §1.6045-5(d)(4).



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Paid to You (attorney)

Example 1

- ▶ You successfully sue Defendant for your client's back wages and settle for \$300,000.
- ▶ Defendant writes a settlement check payable jointly to you and your client.
- ▶ Defendant gives you the check, and you retain \$100,000 for legal services and give the \$200,000 to your client.
- ▶ Defendant must file a 1099-MISC for your client, putting \$300,000 in box 3, AND a 1099-MISC for you putting \$300,000 in box 14.

Paid to You (attorney)

Example 2

- ▶ You represent a client who successfully sues for damages stemming from a personal physical injury and settle for \$300,000.
- ▶ They physical injury award is excluded from you client's gross income because of IRC §104.
- ▶ Defendant writes the \$300,000 check payable to you and your client, of which you retain \$120,000 for your services and remit the remaining \$180,000 to your client.
- ▶ Defendant must file a 1099-MISC for YOU, putting \$300,000 in box 14, but Defendant does NOT have to file a 1099-MISC for your client.

Paid to You (attorney)

Example 3

- ▶ You successfully sue for a client and recover \$300,000 from Defendant, which is included in your client's gross income.
- ▶ You instruct Defendant to issue two checks: \$200,000 to your client and \$100,000 to yourself for legal fees.
- ▶ Defendant file a 1099-MISC for YOU putting \$100,000 in box 14, AND a 1099-MISC for your client, putting \$300,000 in box 3.

Paid by You

You generally do NOT have to report payment to your clients. However, there are exceptions.

Under the regulations, you as an attorney need to issue a 1099-MISC if one of the following is true:

- 1. You perform management or oversight functions in connection with the litigation recovery. This excludes the ministerial function of writing a check to your client.
- 2. You have a significant economic interest in the litigation recovery such that your interest would be compromised if the payment were not made (e.g., a lien existed).

Treas. Reg. §1.6041-1(e)(1)

However, the oversight and economic interest tests are payee specific, i.e., with respect to the specific recipient, have you met one of the two tests?



Paid by You

Example 1

- ▶ You receive a settlement payment from Defendant and deposit the funds into your IOLTA account.
- ▶ You make payments to service providers (e.g., expert witnesses, private investigators) incurred during litigation. You decide who to hire, negotiated amounts, and handle disputes about payment thereof.
- ▶ With respect to these payments, you ARE performing management or oversight functions and are required to 1099 the payee.



Paid by You

Example 2

- ▶ Same as previous example, but at the end of the day you pay the remaining funds (net legal fees) to the client.
- ▶ You are not performing management or oversight functions with respect to that payment and are NOT required to 1099 your client.



State Law Concerns

Variance in Reporting

- ▶ There is little or no independent reporting requirement at the State level. 1099 information is generally shared between the IRS and FTB and no separate filing is necessary

Variance on Income Doctrines

- ▶ There are significant income doctrine differences.



Different Approach to Income

Under the first question (i.e., what does the payment represent), there is no change to the reporting requirement, but the taxation thereof may be different for State law purposes.

- ▶ California follows the Federal definition of gross income, unless specified elsewhere. Cal. Rev. & Tax. Code §17071. Thus gross income for California purposes still includes:
 - ▶ Awards and Prizes,
 - ▶ Cancellation of Debt
 - ▶ Attorney Fees
- ▶ California follows the Federal definition of items specifically excluded from gross income, unless specified elsewhere. Cal. Rev. & Tax. Code §17131.



Different Approaches to Income

The critical difference for our purposes is the exclusions from discharge of indebtedness income, namely the "qualified principal residence indebtedness" exclusion.

- ▶ Under Federal law, the exclusion applies to a discharged debt that occurs before January 1, 2013.
 - ▶ The previous version allowed for the exclusion only if the discharge occurred before January 1, 2010.
 - ▶ However the passage of Pub. L. 110-343 (Emergency Economic Stabilization Act of 2008) changed the date to apply to discharges up to January 1, 2013.
- ▶ Under California law, no corresponding extension was passed. The California exclusion for "qualified principle residence indebtedness" applies to discharges before January 1, 2009. Cal. Rev. & Tax. Code §17144.5(b).


