

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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date: August 9, 2012

to: _____, Global Team Manager
_____, Account Coordinator
_____, Team Manager
_____, Employment Tax Specialist

from: Steven G. Cappellino
Senior Attorney (Detroit)
(Large Business & International)

subject: Form 1099 Requirements for Claims

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Claims =
X =

ISSUES

1. Is there a Form 1099 filing requirement for Taxpayer with respect to settlement amounts paid to its customers in settlement of Claims?
2. Is there a Form 1099 filing requirement for Taxpayer with respect to settlement amounts paid to attorneys representing Taxpayer customers pursuing claims?

CONCLUSIONS

1. Taxpayer does not have a Form 1099 filing requirement for amounts paid to its customers in settlement of Claims unless it is aware the payment (or any portion of such payment) is income to its customer.
2. Taxpayer does have a Form 1099 filing requirement for amounts paid to attorneys in conjunction with settlements of Claims.

FACTS

Taxpayer is in the business of selling X to its customers. Occasionally, X has manufacturing defects or requires repeated repairs. Federal and state laws were enacted to protect consumers in these situations by providing a basis for submitting claims against the manufacturers. The manufacturer may be obligated to pay the customer's attorney fees in a successful suit. For some of the customer claims submitted against Taxpayer under these laws, the company reaches a settlement with the customer and makes payments to resolve any potential liability. Payments are made in one of two ways:

1. on one check with both the customer's name and the attorney on the check, which is then sent to the attorney (i.e., the check includes both the attorney fees and the amount that will go to the customer). The attorney then takes its fees from the check and distributes the remainder to their client; or
2. on two different checks, with one check to the attorney for their fees, and another check to the customer for the balance of the settlement.

LAW

Section 6041(a) of the Internal Revenue Code, as amended (the "Code") 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...other than payments with respect to which a statement is required under the authority of ...6045), of \$600 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, 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.

Treas. Reg. § 1.6041-1(a)(1)(i) notes that information returns are required for payments

made “in the course of its trade or business to another person of *fixed or determinable income*.”¹ Income is “fixed” when “paid in amounts definitely predetermined” pursuant to Treas. Reg. § 1.6041-1(c), and is “determinable” when “there is a basis of calculation by which the amount to be paid may be ascertained.” The fixed and determinable income requirement is not met, however, when the payor does not know whether a payment is income to a payee, as described in PLR 201147014.²

Because section 6041(a) is conditioned on a payor knowing that a payment to a payee is in the nature of income and the amount of such income, if a payor cannot determine either that a payment is in the nature of income or in what amount, then the payor is not required to file an information return under section 6041(a).

If the payor is aware of the amount of its payment that is income to the payee, it reports that amount under section 6041.³ Treas. Reg. § 1.6041-1(f)(1) notes that the amount to report will often 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,” and the following examples are provided in Treas. Reg. § 1.6041-1(f)(2):

Example 1. Attorney P represents client Q in a breach of contract action for lost profits against defendant R. R settles the case for \$100,000 damages and \$40,000 for attorney fees. Under applicable law, the full \$140,000 is includible in Q's gross taxable income. R issues a check payable to P and Q in the amount of \$140,000. R is required to make an information return reporting a payment to Q in the amount of \$140,000. For the rules with respect to R's obligation to report the payment to P, see section 6045(f) and the regulations thereunder.

Example 2. Assume the same facts as in Example 1, except that R issues a check to Q for \$100,000 and a separate check to P for \$40,000. R is required to make an information return reporting a payment to Q in the amount of \$140,000. For the rules with respect to R's obligation to report the payment to P, see section 6045(f) and the regulations thereunder.

Section 6045(f) focuses on the reporting requirements when payments are made to attorneys. Section 6045(f)(1)(A) states that a return is required when a person engaged in a trade or business makes any payment to an attorney in connection with legal services in the course of its trade or business, whether or not such services are

¹ (emphasis added).

² See PLR 201147014, Nov. 25, 2011. The PLR cites Rev. Rul. 80-22 as authority for the premise, noting the following example from the Revenue Ruling: “the Service held in Rev. Rul. 80-22, 1980-1 C.B. 286, that an insurance company was not required to file returns under section 6041(a) for crop insurance proceeds paid to certain farmers because the insurer did not know if the payments were income to the farmers. For farmers who had informed the insurance company that they were required to capitalize farming expenses, the amount of insurance proceeds constituting income depended on each farmer's basis in the destroyed crops. That information was not known to the insurance company, and the company could not require the farmers to disclose the information. As the revenue ruling illustrates, however, the facts and circumstances must render the income not fixed and determinable.

³ See Treas. Reg. § 1.6041-1(f).

performed for the *payor*.⁴ “Payor” is defined under Treas. Reg. § 1.6045-5(d)(3) to include “a person who makes a payment if that person is an obligor on the payment, including a person who pays a settlement amount to an attorney of a client who has asserted a tort, contract, violation of law, or workers' compensation claim against that person.” An exception applies for whatever portion of the payment is required to be reported under section 6041(a).⁵

Treas. Reg. § 1.6045-5(a)(1) provides additional guidance on reporting payments to attorneys. The regulation notes that the reporting requirement applies whether or not a portion of a payment is kept by the attorney as compensation for legal services rendered, or other information returns are required with respect to some or all of a payment. Treas. Reg. § 1.6045-5(f) also provides the following examples:⁶

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. P also must file an information return with respect to C under sections 6041 and 6051, in the amount of \$300,000. See §§ 1.6041-1(f) and 1.6041-2.

Example 2. One check--joint payees--excludable to claimant. C, who sues corporation P for damages on account of personal physical injuries, is represented by attorney A. P settles the suit for a \$300,000 damage payment that is excludable from C's gross income under section 104(a)(2). P writes a \$300,000 settlement check payable jointly to C and A and delivers the check to A. A retains \$120,000 of the payment as compensation for legal services and remits the remaining \$180,000 to C. P must file an information return with respect to A for \$300,000 under paragraph (a)(1) of this section. P does not file an information return with respect to tax-free damages paid to C.

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.

ANALYSIS

1. Form 1099 Reporting to Customers for Claims

⁴ (Emphasis added).

⁵ See section 6045(f)(1)(B). See also Treas. Reg. § 1.6041-1(a)(1).

⁶ The regulation notes that the examples assume that P is not a payor with respect to A, the attorney, under section 6041, and that section 6041 should be consulted on filing requirements pertaining to C.

Under section 6041 and Treas. Reg. § 1.6041-1(a)(1), the settlement payments made by Taxpayer on _____ claims are in fact made in the course of its trade or business, but the issue is whether such payments are “fixed and determinable income” under Treas. Reg. § 1.6041-1(c). Taxpayer has indicated that it does not know whether the _____ payments constitute income to its customers because its customers did not disclose their basis in X, similar to the scenario described in Rev. Rul. 80-22. Therefore, under either factual scenario presented by the taxpayer (i.e. making the settlement payment via a dual party check sent to the attorney or via two separate checks to the attorney and customer), such payments will not be considered “fixed and determinable income,” and there is not a Form 1099 filing requirement.

If Taxpayer is aware of the amount of income that a customer would recognize, such amount would be fixed and determinable income, and Taxpayer would have a Form 1099 filing requirement. Under either scenario (dual or separate checks), the full amount of settlement (including attorney fees) would be reportable as described in Examples 1 and 2 under Treas. Reg. § 1.6041-f(2).

2. Form 1099 Reporting to Attorneys for Claims

Taxpayer will have a reporting requirement with respect to the attorneys under either factual scenario described above regardless of whether the settlement paid by Taxpayer is income to its customer. Under section 6045(f)(1)(A) and Treas. Reg. § 1.6045-5(d)(3), Taxpayer is a payor who has made payment to an attorney in connection with legal services (in this case, in settlement of a claim against Taxpayer), thereby requiring the issuance of a Form 1099 to such attorney. The amount reportable on the Form 1099 to the attorney will depend on the factual scenario presented by the taxpayer.

Under the first scenario where a dual-party check for the full settlement amount is issued to the attorney, Taxpayer will issue a Form 1099 to the attorney for the full amount of the check as described in Examples 1 and 2 of Treas. Reg. § 1.6045-5(f). This includes the portion which ultimately will be distributed by the attorney to the customer after fees are subtracted out. Under the second scenario in which separate checks are issued to the attorney and to the customer, Taxpayer will issue a Form 1099 to the attorney for only the amount issued to the attorney, as described in Example 3 of Treas. Reg. § 1.6045-5(f).

Please call (313) 628-3100 if you have any further questions.

ERIC R. SKINNER
Associate Area Counsel
(Large Business & International)

By: _____
Steven G. Cappellino
Senior Attorney (Detroit)
(Large Business & International)