

Internal Revenue Service

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CC:IT&A:2 – COR-105594-01
Date: March 16, 2001

Dear [REDACTED]:

This letter is in response to your letter dated January 13, 2001, inquiring about the tax and reporting consequences of a litigation settlement and related attorney's fees. You set forth a situation in which a taxpayer obtains a settlement amount, which is paid into a trust account of the attorney who represented that taxpayer. You ask whether the taxpayer, the attorney, or both must report the settlement amount in income. You also ask who is responsible for filing Forms 1099 regarding the transaction.

We cannot issue you a private letter ruling containing specific guidance upon which you may rely because you have not met the requirements of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, a copy of which is enclosed. We are pleased, however, to provide you with general information.

Your first question concerns who is required to include the settlement amount in income. Under § 61 of the Internal Revenue Code, a taxpayer must include in gross income all income from whatever source derived, unless the Code provides a specific exclusion.

In determining the tax treatment of damages received in a settlement agreement, the proper inquiry is: in lieu of what were the damages awarded? This determination is made in light of all the facts and circumstances surrounding the case. For example, to the extent that a recovery represents lost profits, it is taxable income. If, however, a taxpayer can show that a recovery represents a reimbursement for injury to goodwill or other assets, it is a return of capital, taxable only to the extent the recovery exceeds the taxpayer's basis in the asset.

Generally, a taxpayer must include the entire amount of a taxable award in his gross income, even though the award is paid to his attorney who retains a portion as his fee. Thus, in Benci-Woodward v. Commissioner, 219 F.3d 941 (9th Cir. 2000), the court held that taxpayers were required to include in their income the portion of a punitive damages recovery that was retained by their attorney as an attorney's fee under a contingency fee agreement entered into under California law.

A taxpayer may be able to deduct the attorney fee portion of a settlement award if, for example, it is an ordinary and necessary business expense under § 162 or an expense to produce or collect income under § 212. Other provisions of the Code, however, may limit or disallow an otherwise deductible expense. For example if the attorney's fee, whether it

COR-105594-01

is a business expense or an expense to produce income, is a miscellaneous itemized deduction under § 67, then the fee is deductible only to the extent that the aggregate amount of miscellaneous itemized deductions exceeds two percent of the taxpayer's adjusted gross income. In addition, § 56 provides that miscellaneous itemized deductions are not allowed as deductions for purposes of computing alternative minimum tax ("AMT") liability.

Section 61 also requires the attorney to include in income the portion of the award he or she retains as an attorney's fee.

Your second question concerns who is responsible for filing Forms 1099. Under § 6041, a person engaged in a trade or business and who in the course of that trade or business makes payments of \$600 or more during the taxable year to another person generally is required to issue an information return for such payment. Thus, a taxpayer who obtains a settlement may be required to report on Forms 1099 the amount retained by his or her attorney as a fee, if that payment was made in the course of the taxpayer's trade or business. In addition, under § 6041 a person who in the course of a trade or business pays a taxable settlement may be required to report on Forms 1099 the full amount of that payment to the person who obtained the settlement ("claimant").

Moreover, under § 6045(f), a person engaged in a trade or business and making a payment in the course of that trade or business to an attorney in connection with legal services (whether or not the services are performed for the payor) generally must file an information return with respect to such payment. Thus, a person who in the course of a trade or business pays a settlement check to the claimant's attorney or jointly to the claimant and his or her attorney may be required to file an information return under § 6045(f) in the amount of the settlement with respect to the attorney. This reporting requirement is in addition to the requirement under § 6041.

I hope this information is helpful. Please call Sean Dwyer at the number above, if you have any questions.

Sincerely,

Associate Chief Counsel
(Income Tax & Accounting)

By _____
Michael J. Montemurro
Senior Technician Reviewer, Branch 2

Enclosure
Rev. Proc. 2001-1