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Collateral Damage: Inaccurate US Tax Reporting Can Give Rise to Customer Damages: Mayer Brown

Financial institutions, corporations, and other payors of income are keenly aware that the Internal Revenue Service ("IRS") will impose tax penalties on them if they issue inaccurate tax information returns to either the IRS or customers. A recent case, however, points out that inaccurate reporting may have another, less obvious, downside: liability to the customer who received the inaccurate information. On June 30, 2022, a United States district court in New Jersey allowed a brokerage customer to proceed to seek damages from a brokerage that provided inaccurate tax reporting to the customer.1 While the opinion did not decide whether the brokerage was liable for damages, it has allowed the customer to continue its lawsuit.

In Goodman, the brokerage customer (the "plaintiff") purchased a number of taxable municipal bonds at a premium to the face amount of the bonds. The plaintiff held the bonds in a brokerage account. When a taxpayer purchases bonds for an amount greater than their face value (i.e., at a premium), U.S. tax law permits the taxpayer to amortize the premium over the remaining life of the bond. The premium amortization reduces the taxpayer's taxable income.2 Treasury Regulations contain certain presumption rules relating to a broker's IRS Form 1099 reporting obligations when a customer holds instruments that were purchased at a premium in an account with that broker.3 In Goodman, the plaintiff alleged that the broker incorrectly reported the amount of amortized bond premium on the plaintiff's IRS Forms 1099 for tax years 2015 – 2018. The plaintiff alleged that the misreporting caused the plaintiff to overpay U.S. federal income taxes in those years. The plaintiff brought contract and tort claims on behalf of himself and similarly situated individuals. In response, the broker filed a motion to dismiss.

The court looked to the underlying agreements governing the relationship between the plaintiff and broker in determining whether the plaintiff had a claim against the broker. While nothing in the account agreements specifically addressed the broker's tax reporting policies related to municipal bonds, the agreements did contain provisions relating to specific tax forms, including, for example, the electronic delivery of IRS Forms 1099. The court further noted that the broker also has a Form 1099 guide that it provides to clients. The guide, consistent with the Treasury Regulations, stated that the broker would report a gross amount for both the interest paid to the holder and the premium amortization for the year unless a holder requests otherwise.

The broker sought to have the litigation dismissed. The court denied the broker's motion to dismiss based on the possibility that the client had two potentially viable claims: (i) breach of contract and (ii) negligence. The court found it plausible that the broker violated implied terms of the agreements, providing the plaintiff a breach of contract claim. The court held that the agreements clearly contemplate that the broker would provide the plaintiff with tax forms, including IRS Form 1099. The court explained a promise to provide the client with tax forms, to be meaningful, implies that the forms be accurate to the best of the broker's knowledge. Second, it implies the broker would follow its own stated policies (i.e., the Form 1099 guide) when providing tax forms, even if those stated policies were not themselves part of the account agreements.4

The court held, with respect to the negligence claim, the threshold question is whether the broker had a state law duty to accurately report tax information on the forms it provided to the plaintiff. The court, recognizing this is a fact-intensive inquiry, denied the broker's motion to dismiss and found it appropriate to allow the parties to proceed to discovery. (We note that this claim could be rejected in a future motion for summary judgment made by the broker.)

Takeaways

Tax reporting has never been as complicated as it is today. Basis reporting, wash sale reporting, and a host of other relatively new reporting requirements substantially increase the likelihood that payors inadvertently misreport information. The Goodman opinion highlights the need to carefully review existing client/customer documentation to see what, if anything, is agreed or promised to clients, customers, or payees in terms of information reporting. At the very least, taxpayers should consider whether such documentation should contain an acknowledgement by the client/customer/payee that the broker is not liable for inadvertent tax reporting errors.

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1 Goodman v. UBS Fin. Servs., Inc., No. Civ. No. 21-18123 (KM) (MAH), 2022 BL 228030 (D.N.J. June 30, 2022).

2 See Internal Revenue Code section 171.

3 Treasury Regulation section 1.6045-1(n)(5).

4 The court's opinion provided the following: "A client who wonders how his or her income will be reported would naturally look for answers in the materials provided by [the broker] and would expect [the broker] to follow those policies. Here, [the broker] 1099 Guide stated 'unless you notified [the broker] in writing in accordance with Regulations section 1.6045-1(n)(5) that you did not want to amortize the premium under section 171, we will report a gross amount for both the interest paid to you and the premium amortization for the year.' The contract implies, therefore, that the Form 1099 that [the broker] was contractually and legally obligated to provide to clients such as [the plaintiff] would 'report a gross amount for both the interest paid to you and the premium amortization for the year.' [The plaintiff] alleges that the Form 1099s provided to him did not report the premium amortization for that year and therefore has plausibly alleged a breach of contract."

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