Attorney Fee Deduction Problems Remain

By Robert W. Wood

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In 2005 the Supreme Court ruled that attorney fees are generally income to contingent fee clients, prompting many taxpayers to scramble for ways to deduct the fees. Many plaintiffs continue to face problems with fee deductibility, and only imperfect solutions exist.

I see attorney fee tax problems virtually every day. Thus, I admit to being myopic about them. Nevertheless, I believe they remain a huge problem not just for my clients but for thousands (if not hundreds of thousands) of litigants every year. The problem is caused by the interaction of the Supreme Court's general inclusion in income rule announced in *Commissioner v. Banks*[1] and by the limited ways taxpayers can deduct legal fees.

Banks resolved a split in the circuits, with the Court holding that a client generally has income when the contingent fee lawyer is paid. Congress took on this issue in 2004.[2] A new above-the-line deduction resolved the issue as it relates to employment litigation and federal False Claims Act cases.

Before examining the contexts in which the above-the-line deduction applies, I want to address the various circumstances in which the deductibility issue is problematic. Clients and advisers often fail to plan before it is too late. Consider the following example:

Assume two clients, X and Y, each with a $1 million recovery and each paying a 50 percent contingent fee. X's case arises in employment. Y's case is for any nonphysical tort outside of employment (an example would be intentional infliction of emotional distress). X would include the $1 million and deduct the $500,000 above-the-line, giving him $500,000 of adjusted gross income. With no other income and assuming single status and a standard deduction, X's federal income tax would be $140,041, and his California income tax would be $42,516.[3] With a total tax burden of roughly $183,000, X would take home about $317,000 after taxes.

Y also would have $1 million of gross income, but his $500,000 in legal fees can be deducted only as a miscellaneous itemized deduction. With no other income and single status, Y would owe $276,500 in federal income taxes and California tax of $72,500, for a total tax burden of $349,000. Y thus takes home $151,000 from the $1 million recovery.

If one alters the example to increase the attorney fees X and Y incur to 80 percent, the comparison becomes even more striking. (Attorney fees can and do reach such levels in some cases, as I will describe.) Each client nets $200,000 from the $1 million gross after attorney fees. Based on gross income of $1 million and an $800,000 above-the-line attorney fee deduction, X would pay federal income tax of $43,550 and California tax of $13,670 for a take home of roughly $142,000.

With the same $200,000 recovery after attorney fees, Y would have gross income of $1 million and only a miscellaneous itemized deduction for the $800,000 in fees, yielding $276,500 in federal income tax and $72,500 in California tax ("AMT"). Y ends up with a total tax burden of $349,000 — the same as in the previous example — because of the alternative minimum tax. Thus, Y actually *loses* $149,000 by winning his $1 million recovery.

As these figures reveal, there is a shocking disparity between cases in which an above-the-line

[1]543 U.S. 426 (2005).

[2]Section 703 of the American Jobs Creation Act of 2004 (P.L. 108-357).

[3]I will use California tax throughout this article, but those in other states may want to substitute their own state taxes.

deduction is available and those in which one is not. Like any AMT-based calculation, it is not enough to say that some portion of the deduction will be reduced or unavailable. A comparison of the client's tax return assuming an above-the-line versus below-the-line deduction is hard to estimate.

The contingency fee arrangement is not usually (in my experience) a simple one-third/two-thirds split between lawyer and client. Society may think of the typical contingent attorney fee as one-third, but figures of 50 percent and beyond are common, with additional costs exceeding 10 percent of the recovery in many types of cases.

Costs are generally treated in the same manner as attorney fees for purposes of the deduction.[4] If you are asked for tax advice as a case is settling, it is important to obtain cost information even if the last few bills have not yet come in and must be estimated. If costs already total $150,000, do not simply ignore them and use the percentages in the contingent fee agreement. Use actual numbers whenever possible.

Lawyer Percentages

Sometimes percentage contingent fees may seem shocking, but they are based on a different business model than that used by hourly advisers. In cases that are appealed post-verdict, it is common for there to be several sets of lawyers. Appellate lawyers have different expertise than trial lawyers, and many trial lawyers do not want to go it alone on appeal. Some lawyers and clients may be willing to negotiate a flat fee with the appellate lawyer, but contingent fee arrangements are still common.

In contingent fee cases, each lawyer is working for a piece of any ultimate recovery. I have seen cases resolved by an appellate court or settled during an appeal in which the combined contingent attorney fees range between 70 and 80 percent. Thus, comparisons such as the one between X and Y in our second fact pattern are not so far-fetched.

Clients and practitioners have an incentive to consider each of the claims presented in section 62(a)(20) — and its companion, section 62(e) — in search of an above-the-line deduction for fees and costs. Among the lesser known of these claims is section 1983 suits for violations of civil rights. Also on the list are claims for violations of the National Labor Relations Act, the Family and Medical Leave Act, and the Fair Housing Act.

Allocating Above Versus Below-the-Line?

Allocation questions about attorney fees arise frequently. Suppose a case is predominantly about libel and slander but also includes section 1983 claims. Does invoking section 1983 mean that all the contingent attorney fees may be deducted above-the-line? I don't think anyone wants to ask this question. Perhaps the reasons are obvious. If the claims in the case include one of those enumerated in the relevant statutes, many lawyers (and surely some tax advisers) will simply assume an above-the-line deduction for all the fees and costs must be available.

The IRS has ruled that attorney fees should be allocated between those producing taxable amounts and those producing tax-free amounts.[5] Likewise, the IRS has ruled that attorney fees in a divorce must be allocated between general (nondeductible) fees and those for tax advice, which are deductible below-the-line.[6] The IRS has even required bifurcation of attorney fees between ordinary and capital matters.[7]

The presumptive method of allocation is pro rata. Thus, if an attorney charges $300,000 for services related to a suit for both taxable and tax-free damages, yielding a $1 million recovery that is 50 percent taxable and 50 percent tax free, the attorney fees would be proportionately split.[8] This is the presumptive method most people seem to use and it is usually above reproach. Of course, it may not be so clear that the recovery is truly 50-50 in the taxable and tax-free categories, but once that position is taken, the attorney fee position flows from it.

An alternative to this allocation method relies not on the pro rata presumption but on an attempt to document actual time, and therefore money, spent. Suppose the lawyer charging $300,000 on the same 50-50 $1 million recovery has time records establishing that he spent 75 percent of his time on recovering the tax-free award and only 25 percent of his time recovering taxable money. That should presumably be sufficient to allocate the legal fees 75-25 despite the 50-50 nature of the recovery.[9]

These methods are not always exact. If there are no time records to make this allocation, will a declaration from the attorney suffice? What about a combination of time records coupled with a declaration, and supported by memos on the substantive law, motions, and other documents proving that more time was spent on some aspects of the case?

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[4]*See* section 62(a)(20).

[5]*See Metzger v. Commissioner*, 88 T.C. 834 (1987).

[6]Rev. Rul. 72-545, 1972-2 C.B. 179; *see United States v. Gilmore*, 372 U.S. 39 (1963).

[7]*See Eisler v. Commissioner*, 59 T.C. 634 (1973).

[8]*Robinson v. Commissioner*, 102 T.C. 116, 137 n.15 (1994).

[9]*Alexander v. Commissioner*, 72 F.3d 938 (1st Cir. 1995), *Doc 96-602*, *96 TNT 1-74*.

As in all such evidentiary matters, the more documentation the better, particularly if the desired allocation produces a tax advantage (as it always will).

The allocation concept often applies to punitive damages and interest in the context of contingent fee personal (physical) injury litigation. Contingent legal fees paid to obtain punitive damages and interest are generally included in income under *Banks*, even if the case is primarily about damages for personal physical injury or wrongful death.[10] In true physical injury cases, we generally do not worry about the *Banks* problem. It matters little if we consider only the client's share of the recovery or the entire recovery including the attorney fees and costs.

If the entire recovery is excludable under section 104, of course, *Banks* is irrelevant. That is not true, however, when punitive damages or interest are involved. Many plaintiff lawyers and some tax advisers may miss this issue. Thus, if a libel and slander action also includes a section 1983 claim, does the presence of the latter mean all legal fees qualify for the above-the-line deduction?

I believe the Service may be construing the deduction provided by section 62(a)(20) as broadly as it can. I hope this is the view adopted nationally by examination and Appeals personnel who consider the issue of legal fee deductibility when it arises.[11] A narrow view of the above-the-line deduction seems both unjust and counterintuitive.

Take, for example, federal and state False Claims Act actions. Only the federal False Claims Act is mentioned in section 62(e)(17). If a taxpayer brings both a federal False Claims Act claim and a state counterpart claim, it seems conceivable that legal fees should be allocated between the two, with only the fees attributable to the federal case being deductible above the line.

Presumably, it would be easy to treat all the fees as deductible above-the-line in any case arising from an employment claim. Take, for example, a case asserting breach of contract, fraud, and various other claims, including wrongful termination. The damages claimed by the plaintiff may indicate that the employment part of the case is small, perhaps 10 percent, while the gravamen is based on other claims. Because section 62(e) covers so many types of employment claims and even includes an important catchall category in section 62(e)(18), my guess is that most advisers would not worry about allocating fees in such a case. Other fact patterns may not be as clear.

Injunctive Relief

Injunctive relief issues come up less frequently than the others previously discussed, but they can be troublesome when they do. Suppose $100,000 of a recovery is pocketed by the plaintiff while the remaining $900,000 goes to the lawyers. This scenario might arise if the bulk of the fees relate to injunctive relief. In employment cases, an above-the-line deduction would surely be available for all the fees. The same would presumably be true in civil rights cases. Outside these areas, however, it may not be as clear.

Banks did not decide the treatment of legal fees related to injunctive relief, so it is still uncertain whether those fees would be income to the client. Another topic sidestepped in *Banks* is statutory fees. I have also argued that the partnership theory, not addressed in *Banks*, is worth more thought than most give it.[12]

These issues can put taxpayers in the awkward position of arguing that the legal fees really aren't income so they can be netted, but if they *do* represent income, they can be deducted above the line. This can present interesting disclosure and statute of limitations questions.

Schedule C

There can also be interesting Schedule C questions. Some taxpayers who have exhausted other arguments for either excluding legal fees from their gross income or for deducting them above-the-line may turn to Schedule C.[13] If the gross recovery and the related legal fees belong on Schedule C, they are netted before going to the face of the return.

Of course, if a recovery and legal fees are netted on Schedule C, they are subject to self-employment tax. Clients sometimes file a Schedule C and don't pay the self-employment tax, presumably in error. Most of the time I have seen Schedules C filed when the client has a history of filing them, there are good arguments that the lawsuit is really about the business, and self-employment tax is addressed. In other cases, however, Schedules C were filed when there were few arguments that could withstand scrutiny.

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[10]*See Kovacs v. Commissioner*, 100 T.C. 124 (1993), *Doc 93-2636*, *93 TNT 45-22*; *aff'd*, 25 F.3d 1048 (6th Cir. 1994), *Doc 94-6133*, *94 TNT 126-16*.

[11]*See* "Service Explains Tax Consequences and Reporting Obligations for Employment-Related Settlement Payments," PMTA 2009-035, *Doc 2009-15305*, *2009 TNT 129-19*; *see also* Robert W. Wood, "IRS Speaks Out on Employment Lawsuit Settlements," *Tax Notes*, Sept. 14, 2009, p. 1091, *Doc 2009-18678*, or *2009 TNT 175-4*.

[12]Wood, "Attorney-Client Partnerships With a Straight Face," *Tax Notes*, Oct. 18, 2010, p. 355, *Doc 2010-20564*, *2010 TNT 203-6*.

[13]*See Alexander v. Commissioner*, 72 F.3d 938 (1st Cir. 1995).

Conclusion

Despite the large numbers of lawsuits involving contingent fee attorneys, there are still many clients who are surprised that their attorney fees and costs must be claimed as miscellaneous itemized deductions. The only cases that circumvent these rules involve personal physical injuries, employment and discrimination claims, and the federal False Claims Act.

There can be surprises even in those cases, however, such as when a personal physical injury case involves punitive damages or interest. Legal fees must generally be allocated in those circumstances. Many practitioners miss this issue or do not handle it well.

Given the vast numbers of cases and taxpayers affected, it would be nice if we had a more elegant and permanent solution to these cases. One can argue that it was unfortunate that discrimination and employment claims and federal False Claims Act claims were addressed by Congress in 2004 with an above-the-line deduction. Before that, employment lawyers were quite vocal about the inequity of legal fee deductions. Few people today talk widely of this problem. That can make the legal fee deductibility issue even more of a stealth tax problem than it used to be.