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Tax Notes

Special Reports

FEBRUARY 26, 96

ATTORNEYS' FEES HELD TO BE BELOW THE LINE DEDUCTION.

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In this article, Wood reviews a recent case, Alexander v. IRS, that deals with the deductibility of attorneys' fees.

Table of Contents

Are attorneys' fees deductible by plaintiffs in employment cases? At first glance, the question may seem silly. Indeed, virtually the only amelioration to high legal fees may be the broad notion that attorneys' fees paid are deductible.

Nonetheless, even a casual observer must recognize that not all attorneys' fees are deductible. For example, some attorneys' fees relate to purely personal matters and therefore cannot be deducted. Perhaps the best example would be attorneys' fees paid in connection with a divorce. The famous case standing for this proposition is U.S. v. Gilmore, 372 U.S. 39, 63-1 U.S.T.C. par. 9285, 11 AFTR2d 758 (1963). In that case, a dispute reached the U.S. Supreme Court over whether a man attempting to keep his car dealerships away from his wife in a divorce was incurring trade or business (or investment) expenses in paying the attorneys' fees, or was merely fighting a personal battle. The Supreme Court held that the origin of the claim and the nature of the dispute was personal (the divorce), and hence disallowed the attorneys' fees deduction. (Note, of course, that certain attorneys' fees in a divorce action can be deducted, when the fees relate to tax advice.)

Still other attorneys' fees cannot be deducted, but must be "capitalized." When something is capitalized, it gives rise to tax benefits, but only spread over a number of years. The useful life of the asset (to which the attorneys' fees relate) must be determined, and then the attorneys' fees can only be deducted according to a prescribed percentage schedule over the course of that useful life. For example, when a taxpayer buys a piece of property and then has to litigate a cloud over its title, the attorneys' fees paid in connection with that litigation must be capitalized rather than deducted. Under the origin of the claims test, the claim has its root in a capital asset (the real estate), and hence the attorneys' fees must be capitalized.

What about a garden variety personal injury case (such as a car accident)? If the injured plaintiff recovers $300,000, but spends $100,000 in attorneys' fees to get it, are the legal fees deductible? The answer is no, since the $300,000 recovery would be excludible from income under section 104 of the Internal Revenue Code. The tax law denies a deduction for the legal fees, since the legal fees were not incurred to produce taxable income. If the legal fees were for a claim that resulted in taxable income --breach of an employment contract, for example -- then the recovery would be taxable and the legal fees deductible.

While these rules may seem straightforward, the precise interaction of what constitutes a tax-free recovery -- and how the legal fees should be treated -- has caused enormous confusion. The confusion is certainly not over yet, particularly in the employment context where a controversy has raged for years about whether certain types of employment claims should be treated as taxable or excludable from income (as a tort recovery). The IRS is digging into this even more today. Fortunately, there is some good news concerning the tax treatment of attorneys' fees in this quirky context.

One important distinction with respect to the deduction of attorneys' fees concerns the difference between ordinary and necessary business expenses (under section 162) and expenses incurred in connection with investment or the production of income (under section 212). This dichotomy is significant because trade or business expenses under section 162 are "above the line," meaning that they are a direct offset to gross income. On the other hand, investment expenses are deductible under section 212 and hence "below the line."

[P. 1280]

These below the line deductions are lumped together with other miscellaneous itemized deductions, and hence do not directly offset gross income. Plus, they are subject to a variety of limitations, including the 2 percent of gross income limit (which essentially "wastes" a portion of the miscellaneous itemized deductions that do not exceed 2 percent of the taxpayer's gross income). This, along with a number of other disadvantages, makes below the line deductions less desirable.

In Alexander v. IRS, No. 95-1451, 77 AFTR2d Par. 96-301, Doc 96- 602 (21 pages) (Dec. 22, 1995), the taxpayer was an employee and executive of a company who was terminated in 1988. Alexander filed suit, alleging breach of his written employment contract, breach of an implied pension benefits contract, and age discrimination under Massachusetts law. In 1989, the parties settled for $350,000. The settlement agreement allocated $100,000 to the age discrimination claim and $250,000 to the breach of contract and pension claim. Withholding taxes were deducted from the $250,000 check.

First, let's look briefly at the allocation Alexander made. He (and his employer) regarded $100,000 of the $350,000 as attributable to the age claim, and therefore tax-free. The Supreme Court has since nixed the tax-free status of most age claims, ruling in Schleier v. Commissioner, 95 AFTR2d Par. 95-947, 95 TNT 116-8 (U.S. S.Ct. June 14, 1995), that recoveries for age discrimination under the ADEA are taxable. Interestingly, it can still be argued that an age recovery under state law (depending a great deal on how the state age discrimination law is written) can be tax-free. Likewise, wrongful termination claims in some states have fared well when it comes to the argument that the recovery is all or partially tax-free.

Normally, the fact that $100,000 out of $350,000 was reported (and apparently accepted by the IRS) as tax-free, would indicate that the attorneys' fees deduction would be limited to the portion of the attorneys' fees attributable to the $250,000 recovery that was included in Alexander's income. Here, that would be approximately 71 percent ($250,000/350,000 = 71 percent). Thus, Alexander would have been entitled to a deduction for 71 percent x total attorneys' fees.

In fact, Alexander is helpful in that it shows that the courts (and perhaps particularly the Tax Court) are willing to look closely at state law claims in assessing whether the tort damage exclusion should apply. Notwithstanding Schleier and the IRS' recent announcement in Notice 95-45 that it was studying the question whether federal gender and race recoveries should be taxable, the tax treatment of many state law claims is still debatable.

On Alexander's 1989 tax return, he reported the $250,000 settlement, but deducted $245,100 for legal fees. The explanation to this deduction indicated that $258,000 in legal fees had actually been spent. However, the explanation indicated that the law firm's time allocations were 95 percent to the settlement of the contract and pension claims, and only 5 percent to the age discrimination claim.

Pro Rata Allocation?

Not surprisingly, the IRS disagreed with at least some of the taxpayer's return. Interestingly, the IRS did not materially reduce the $245,100 deduction for attorneys' fees. In effect, the IRS accepted the notion that one could, by reference to attorney time records, determine what portion of attorneys' fees was attributable to what claims, rather than allocating attorneys' fees merely by the percentage of the attorneys' fees relating to the taxable and the tax-free recoveries. Allocating attorneys' fees based on which percentage of the recovery is taxable and which percentage is tax- free is the standard method of allocating attorneys' fees.

What the IRS did object to was the direct deduction of the legal fees from the settlement recovery, in effect being a direct offset. The IRS said that the attorneys' fee deduction had to be a miscellaneous itemized deduction, and thus subject to the 2 percent of adjusted gross income limitation. This only reduced the attorneys' fee deduction from $245,100 to $240,198.

The most serious effect of this conclusion respected the alternative minimum tax. As a miscellaneous itemized deduction, the large attorneys' fee deduction was enough to result in the taxpayer being liable for the alternative minimum tax under section 55. That AMT liability was $57,441.

Business Expense vs. Miscellaneous Itemized

In the Tax Court, and again on appeal to the First Circuit, the taxpayer argued that his attorneys' fees did not have to be deducted as miscellaneous itemized deductions because they were legitimate trade or business expenses. After all, Alexander argued, he was in the trade or business of performing services as an employee. Consequently, an employment-related lawsuit was a business activity, with the attorneys' fees logically being deducted as business expenses. While this argument had some appeal, the other argument the taxpayer advanced was at least unique: that the legal fee was properly subtracted from the amount realized in order to determine gain from the disposition of his intangible assets (express and implied contracts and the resulting lawsuit). This latter theory relied on sections 1001 and 1016, and was understandably rejected by both courts.

Perhaps the most interesting argument made by the taxpayer was that the payment of the settlement to the taxpayer and his lawyers by joint check from the defendant/employer essentially operated like a reimbursement of employee business expenses. Under the taxpayer's argument, a reimbursed employee business expense would be deducted from gross income when arriving at adjusted gross income. Unfortunately, the Tax Court and the First Circuit both agreed that such joint check arrangements were merely standard operating procedure in all types of litigation, thus not supporting the requisite finding of a reimbursement or other arrangement. Obviously, from a contractual viewpoint it was Alexander who was liable to pay his attorneys.

[P. 1281]

Both the Tax Court and First Circuit addressed the "trade or business" question by noting that the lawsuit (and consequently, the deducted legal fees) were rooted in the taxpayer's employment. After weaving through all of the arguments the taxpayer made about the permissibility of a direct offset of attorneys' fees from gross settlement proceeds, the inapplicability of the miscellaneous itemized deduction limitations, etc., the court determined that the deductions had to be taken below the line.

AMT Problem

Faced with the "below the line" conclusion (that is, that the attorneys' fees could only be deducted as miscellaneous itemized deductions), the court neatly disposed of the applicability of the alternative minimum tax. The AMT was enacted to limit the effect of exclusions, deductions and credits on taxpayers with substantial gross income. The basic idea of the AMT was that high-income taxpayers should not be allowed to use large deductions to effectively wipe out their large income and then pay little or no tax. Hence the name "alternative minimum tax." Its formulae for arriving at AMT applicability has always been somewhat convoluted. That it often catches litigants (like Mr. Alexander) is clear. In response to the argument that in effect Alexander was being denied his attorneys' fee deduction and that this was unfair, the First Circuit said:

"We recognize that, because the amounts involved trigger the AMT and, thus, Taxpayer's deficiency, the outcome smacks of injustice because Taxpayer is effectively robbed of any benefit of the Legal Fee's below the line treatment. While unfortunate for Petitioners here, we disagree that there is inequality of treatment as compared to similarly situated Taxpayers. Although it may seem otherwise, in reality Petitioners have not been denied their below the line deduction of the Legal Fee."

Silver Lining

Given the number of people that run up against this issue, it is perhaps helpful to have a court case -- however it was decided -- at least to draw attention to the problem. The alternative minimum tax can be quite painful, and quite surprising. More importantly, though, the Alexander case is significant for what it does not contest. It states implicitly that attorneys' fees need not be allocated between the claims pro rata according to the taxability of the recovery. If 50 percent of a recovery is excludable from income and 50 percent is taxable, most lawyers (and indeed IRS policy) suggest deducting 50 percent of the legal fees. Alexander supports a different (in this case 95 percent/5 percent!) allocation based on the time spent on each claim.

Admittedly, the question of what proof there is of the attorneys' devotion of time and disbursements to different claims would seem to be necessary. But precisely how much proof on this point will be required is not clear. One would have thought that a 95 percent/5 percent allocation would be considered aggressive no matter what time records showed.

Conclusion

One may read the Alexander decision as an unfortunate taxpayer defeat (because Alexander was in effect denied the benefits of his attorneys' fee deduction by virtue of the application of the alternative minimum tax), or may choose to find the silver lining of attorneys' fee allocations described above. Either way, Alexander is an interesting case that merits some thought by litigators, tax lawyers, and accountants.

Tax Analysts Information

Code Sections: Section 7430 -- Attorney's Fees
Magazine Citation: Tax Notes, Feb. 26, 1996, p. 1279
70 Tax Notes 1279 (Feb. 26, 1996)