Deducting Legal Fees in State Qui Tam Cases

by Robert W. Wood

Today, contingent legal fees feature in a vast array of complex litigation. For example, large intellectual property cases can be handled in this way, either partially or exclusively. Whistleblower claims brought under various federal and state statutes are also often handled for contingent fees. Some of those cases involve tens of millions, or even hundreds of millions of dollars. On big recoveries a legal fee of 40 percent — or any other customary contingent fee — can be a lot of money. The statute under which the claim is made can affect taxes materially. Additional taxes can be an unpleasant surprise for claimants and their lawyers.

Legal Fees Are Income

Generally, amounts paid to a plaintiff’s attorney as legal fees are includable in the income of the plaintiff, even if paid directly to the plaintiff’s attorney by the defendant. For tax purposes, the plaintiff is considered to receive the gross award, including any portion that goes to pay legal fees and costs. The IRS rules for Form 1099 reporting bear this out.

Under current Form 1099 reporting regulations, a defendant or other payer that issues a payment to a plaintiff and a lawyer must issue two Forms 1099. The lawyer should receive one Form 1099 for 100 percent of the money. The client should receive one, too, also for 100 percent.

The lawyer’s Form 1099 may be a gross proceeds Form 1099, with the amount included in box 14 of Form 1099-MISC. Lawyers should take note that this is the best reporting for the lawyer. Money reported as gross proceeds paid to a lawyer is not classified as income. Some of it may be income, of course, but it could also be for a real estate closing or some other client purpose.

The client, however, will invariably receive a Form 1099-MISC that reports 100 percent of the money in either box 3 (other income) or box 7 (non-employee compensation). Box 7 tends to be the more feared of the two. After all, it suggests that self-employment taxes could be due on the amount.

Dollars reported in either box 3 or box 7 on a Form 1099-MISC usually mean that the plaintiff — or the relator in a qui tam case — has that amount of gross income. When you receive a Form 1099 reporting income in box 3 or box 7, you need to put the full amount on your tax return. Not every Form 1099 is correct, of course.

1 31 U.S.C. sections 3729-3733.

Plaintiffs in many other contexts do receive Forms 1099 that they need to explain. For example, I see many seriously injured plaintiffs who should receive lawsuit proceeds tax free for their physical injuries. In some cases, they somehow still receive Forms 1099.

In those cases, they can report the amounts on their tax returns and explain that it was an erroneous Form 1099. The payments were made because of personal physical injuries, so they should be excludable from their income under section 104. Other plaintiffs (and qui tam relators) do not have this argument and must report the gross payments.

The question is how the plaintiff (or relator) deducts the legal fees and costs. Successful whistleblowers might not mind paying tax on their net recoveries. But they understandably do not want to pay taxes on money their lawyers receive.

Some readers might remember tax controversies from the late 1980s that ran all the way up to 2005. Different courts around the country treated legal fees differently. Many courts held that if a plaintiff received only 60 percent of a settlement, the 40 percent paid to his lawyer simply wasn’t the plaintiff’s income.

However, in 2005 the Supreme Court finally resolved a bitter split in the circuit courts about the tax treatment of attorney fees in Banks. The Court held — in general at least — that the plaintiff has 100 percent of the income and must somehow deduct the legal fees. That “somehow” is important.

In 2004, just months before the Supreme Court decided Banks, Congress took action, too. Congress added an above-the-line deduction for attorney fees but only for some types of cases. The above-the-line deduction applies to employment claims and to federal False Claims Act claims.

Beyond that, a deduction for attorney fees and costs would be a miscellaneous itemized deduction. That is below the line, under section 212.

What Is at Stake?

Why care about the above-the-line point? An above-the-line deduction is like an adjustment. For all purposes, after the deduction, your adjusted gross income is lower.

There is no haircut for 2 percent and no phaseout of your deduction based on the size of your income. Moreover, there is no extra tax under the alternative minimum tax. An above-the-line deduction is almost like not having the lawyer fee income in the first place.

In contrast, a below-the-line deduction faces all of those problems. It is aggregated with your other itemized deductions. There is a 2 percent threshold that can hurt a lot. There is a phaseout that starts with surprisingly little income.

And the AMT can mean no deduction at all. Running some tax calculations both ways (above and below) brings the point home in stark terms on almost any set of numbers. In short, the distinction between above-the-line and below-the-line deductions can be momentous.

State False Claims Act Cases

Section 62(a)(20) was enacted as part of the American Jobs Creation Act of 2004. It allows the taxpayer to deduct above-the-line attorney fees and court costs paid by the taxpayer “in connection with any action involving a claim of unlawful discrimination.” The term “unlawful discrimination” for the purposes of section 62(a)(20) is statutorily defined in section 62(e).

The law also allows for the deduction of legal fees connected with many federal whistleblower statutes. Section 62(a)(21) allows for the deduction of legal fees incurred in connection with federal tax whistleblower actions that result in qui tam awards from the IRS. Under section 62(e), any action brought under the federal False Claims Act contains a claim of unlawful discrimination and can qualify for an above-the-line deduction of legal fees.

However, no provision of section 62(a) or section 62(e) includes state false claims acts within the ambit of section 62. Of course, there can sometimes be an overlap.

For example, whistleblower claims often arise out of employment. There is an awfully broad catchall provision of section 62(e)(18). That provision says that a claim of unlawful discrimination includes a claim under any provision of state law “regulating any aspect of the employment relationship including, . . . any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law” (emphasis added).

This language in section 62(e)(18) is nearly identical to the language in section 62(e)(17), which describes the federal False Claims Act. Many states conform. For example, the anti-retaliation language in the federal False Claims Act is materially identical to the anti-retaliation language in the California False Claims Act. 4

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Section 62(e)(17).
The California law’s anti-retaliation provision provides that:

Any employee, contractor, or agent shall be entitled to all relief necessary to make that employee, contractor, or agent whole, if the employee, contractor, or agent is discharged, demoted, suspended, threatened, harassed, or in any other manner discriminated against in the terms and conditions of his employment because of lawful acts done by the employee, contractor, agent, or associated others in furtherance of an action under this section or other efforts to stop one or more violations of this article.9

Of course, not every state whistleblower claim will allege retaliation or specifically cite the anti-retaliation provision in a state False Claims Act. But often, even in a state-only False Claims Act case, the employment law catchall may apply. There might be a connection to a federal False Claims Act case, or the case could relate to employment. Often, either one could be enough to provide the claimant a ticket to an above-the-line deduction for legal fees.

Allocating Among Claims

The above-the-line deduction is available for any action “involving a claim of unlawful discrimination.” Of course, many complaints allege multiple claims. Read literally, this language suggests that if one claim in a lawsuit qualifies as a claim of unlawful discrimination, then all of the legal fees may be deducted under section 62(a)(20).

However, knowing the IRS, you might reasonably assume that there might be some kind of allocation. That is, if only 10 percent of the case is about “unlawful discrimination,” perhaps only 10 percent of the fees would be covered. For example, say you have a tax-free physical injury recovery but 50 percent of the damages are punitive.

How are legal fees handled? In that situation, one must generally treat 50 percent of the legal fees as attributable to each part of the case. If 50 percent of the damages are tax free, 50 percent of the legal fees are too.

That means there is no need to include them in income and try to deduct them. The punitive damages are taxable, and the 50 percent of the legal fees attributable to those damages are also income to the plaintiff. So, the plaintiff must report the gross amount of punitive damages (including the legal fees) and then deduct the fees.

That probably means a miscellaneous itemized deduction, which is treated unfavorably. One end run around this problem is a non-pro rata allocation of legal fees. The IRS says that the presumptive allocation of fees is pro rata.

But you can have another allocation if you can support it. For example, 90 percent of the lawyer time in the case might have been devoted to compensatory damages, with only 10 percent to punitive damages. If lawyer bills and declarations can support that, it could mean large tax savings. Anything better than 50-50 might help.

With this background, should legal fees in False Claims Act and other whistleblower recoveries be allocated in some way? It does not appear that they need to be. I confess that I worried about this issue in 2004 when the above-the-line deduction was enacted.9

However, I have seen no suggestion since that the IRS would require it. I also have not encountered other practitioners who seem worried about it. When one claim qualifies for an above-the-line deduction under section 62(a)(20), I think it is likely that all legal fees allocable to taxable recoveries can be deducted above the line.10

The IRS has provided at least a glimmer of an indication that it might agree. For example, in field attorney advice (FRA 20133501F), the IRS described section 62(e)(18) as providing “an above-the-line deduction for attorney’s fees and costs incurred in an action or proceeding involving any aspect of the employment relationship” (emphasis added). At the very least, that language seems to suggest a liberal application of section 62(e)(18) for actions in which at least one claim involves the employment relationship.

More generally, 12 years have elapsed since the above-the-line deduction was enacted. In that time I have seen large numbers of legal fee deductions claimed, audited, and disputed. In my experience the IRS in the field interprets the above-the-line deduction liberally.

Moreover, I have not seen a single case in which the IRS has tried to allocate legal fees between above-the-line qualifying fees (such as employment) and other legal fees. I have seen cases in which the issue could have been raised but was not.

Deductibility Limits

One detail of the above-the-line deduction that is easy to miss relates to gross income. Normally, of course, a cash-basis taxpayer is eligible to claim a deduction in the year the underlying payment was

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10See also Wood, supra note 6, at A-64.

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8Calif. Gov’t Code section 12653(a).
However, section 62(a)(20) limits the available deduction to the income derived from the underlying claim in the same tax year. Thus, a deduction allowable under section 62(a)(20) cannot offset income derived from any other source or received in any other year. This is usually not a problem, but occasionally it can be. For example, when there is a mixture of hourly and contingent fees, the issues can be thorny and might require professional help.

**Trade or Business**

Before we leave above-the-line versus below-the-line deductions, it is appropriate to consider one additional way that taxpayers could qualify for above-the-line deductions. A taxpayer operating a trade or business and incurring legal fees in that trade or business — contingent or otherwise — need not worry about these issues. In a corporation, limited liability company, partnership, or even a proprietorship, business expenses are above-the-line deductions.

Some plaintiffs have even argued that they were in the business of suing people. A proprietor — a taxpayer operating a business without a legal entity — reports income and loss on Schedule C to his Form 1040. A Schedule C argument doesn’t always fail, but it doesn’t have a good track record. As you might expect, much depends on the facts.

Plaintiffs who have been filing Schedule C for business activities regularly stand a better chance. Fair warning, though: Schedule C is highly likely to be audited, some say more so than any other tax return or portion thereof. Schedule C is also where people writing off their hobby expenses and claiming it as a business report that activity.

**Conclusion**

Don’t fail to consider the income and deduction side of legal fees and costs. Before the 2004 statute changes, the issue got considerable attention, perhaps because employment plaintiffs felt particularly hammered by the tax law. In a few well-publicized cases, plaintiffs actually lost money (after taxes) by winning a case.

Since 2004 employment plaintiffs and their lawyers have mostly been silent. And that has meant that a large number of plaintiffs in other kinds of cases have ended up surprised at tax time. Try not to be one of them.

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11See section 461(a); reg. section 1.461-1(a)(1).
12See, e.g., Alexander v. IRS, 72 F.3d 938 (1st Cir. 1995).
13See id.
14See, e.g., Spina v. Forest Preserve District of Cook County, 207 F. Supp.2d 764 (N.D. Ill. 2002) (in which a Chicago woman who won a sex discrimination suit against her former employer ended up paying $99,000 more in federal income tax than she recovered in her suit).