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# Whistleblowers Can Face Tax Problems

By Robert W. Wood

Whistleblower claims are brought under a variety of federal and state statutes and are usually handled for contingent fees. On big recoveries, a legal fee of 40 percent—or any other customary contingent fee—can be a lot of money. That means the tax treatment of the gross recovery and the legal fees can be a very big issue.

Most plaintiffs and whistleblowers assume that the *most* that could be taxable to them by the Internal Revenue Service (or by their state) is their net recovery. Lawyers often receive the gross amount, deduct their fees, and remit only the balance to the plaintiff or whistleblower. Their net take-home pay after legal fees and costs is not the only money the IRS sees, however.

For many plaintiffs and whistleblowers, the first inkling that the gross recovery may be *their* income is the arrival of Forms 1099 in January. The statute under which the claim is made can impact taxes materially. The oldest whistleblower statute is the federal False Claims Act, dating back to the Civil War. See 31 U.S.C. §§ 3729–3733. However, there are state versions of this law, IRS whistleblower claims, and SEC whistleblower claims. The latter emanate from section 922 of the Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1377 (July 21, 2010).

To say that not all whistleblower claims are created equal when it comes to taxes would be an understatement. Not all claims qualify to have legal fees deductible "above the line," which means essentially off the top, so the whistleblower does not pay any tax on the legal fees. Otherwise, you must claim a miscellaneous itemized deduction, which is subject to a number of limits.

If you obtain a huge recovery and must pay 40 percent or more to your lawyer, you will care very much about what type of deduction you receive for those fees.

## Contingent Fees and Gross Income

Clients often have a hard time understanding this rule. They might ask, "How can I be taxed on something I never received?" Generally, amounts paid to a plaintiff's attorney as legal fees are gross income to the plaintiff, even if paid directly to the plaintiff's attorney by the defendant. See *Comm'r v. Banks*, 543 U.S. 426 (2005). 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 payor 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 actually paid to the attorney. The client should receive one, too, also for 100 percent. The client, however, will invariably receive a Form 1099-MISC that reports 100 percent of the money. When you receive a Form 1099, you must put the full amount on your tax return. Not every Form 1099 is correct, is ordinary income, or is necessarily income at all.

Plaintiffs receive Forms 1099 in many other contexts, which they must explain. For example, plaintiffs who are seriously injured, and who should receive compensatory lawsuit proceeds tax-free for their physical injuries, may *still* receive a Form 1099. In those cases, they can report the amount on their tax return and explain why the Form 1099 was erroneous.

Plaintiffs and whistleblowers do not have this argument because they are required to report the gross payment as their income. The question is how the plaintiff or whistleblower deducts the legal fees and costs. Successful whistleblowers may not mind paying tax on their *net* recoveries, but paying taxes on money their lawyers receive has long been controversial.

In 2005's *Comm'r v. Banks*, the U.S. Supreme Court resolved a bitter split in the circuit courts about the tax treatment of attorney's fees. 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 added an above-the-line deduction for attorney's fees, but only for certain types of cases. The above-the-line deduction applies to any claims under the federal False Claims Act, the National Labor Relations Act, the Fair Labor Standards Act, the Employee Polygraph Protection Act of 1988, and the Worker Adjustment and Retraining Notification Act as well as claims under certain provisions of the Civil Rights Act of 1991, the Congressional Accountability Act of 1995, the Age Discrimination in Employment Act of 1967, the Rehabilitation Act of 1973, the Employee Retirement Income Act of 1974, the Education Amendments of 1972, the Family and Medical Leave Act of 1993, the Civil Rights Act of 1964, the Fair Housing Act, the Americans with Disabilities Act of 1990, chapter 43 of title 38 of the United States Code, and sections 1977, 1979, or 1980 of the Revised Statutes.

The above-the-line deduction also applies to any claim under any provision of federal, state, or local law, whether statutory, regulatory, or common law, that provides for the enforcement of civil rights or regulates any aspect of the employment relationship. Beyond that, a deduction for attorney's fees and costs would be a miscellaneous itemized deduction. That is below-the-line, under I.R.C. Section 212. An above-the-line deduction means you pay no tax on the attorney's fees.

An above-the-line deduction, as a matter of tax mathematics, is like not having the lawyer fee income in the first place. Despite the holding in *Banks*, an above-the-line deduction means paying tax only on your net. In contrast, a below-the-line deduction faces numerous limitations. It is aggregated with your other itemized deductions. There is a two-percent threshold, and there are deduction phase-outs that start with surprisingly little income. These limits can cut deep.

Arguably worst of all, the alternative minimum tax, or AMT, can mean no deduction. It is why in some famous cases, "successful" plaintiffs have actually lost money after attorney's fees and taxes. *Spina v. Forest Preserve Dist. of Cook County*, 207 F. Supp. 2d 764 (N.D. Ill. 2002). Running some tax calculations both ways (with above- and below-the-line deductions) can bring the point home in stark terms with almost any set of numbers. In short, the distinction between above-the-line and below-the-line can be significant.

## SEC Claims

I.R.C. Section 62(a)(20) was enacted as part of the American Jobs Creation Act of 2004. It allows taxpayers to deduct above-the-line attorney's fees and court costs paid by the taxpayer "in connection with any action involving a claim of unlawful discrimination." The term "unlawful discrimination" is defined in I.R.C. Section 62(e).

The law also allows for the deduction of legal fees connected with many *federal* whistleblower statutes. I.R.C. 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 I.R.C. Section 62(a)(20), any action brought under the *federal* False Claims Act is a claim of unlawful discrimination and can therefore qualify for an above-the-line deduction of legal fees. See I.R.C. § 62(e)(17).

However, these provisions do not explicitly include SEC whistleblower claims. Indeed, there are at least some indications that when Dodd-Frank was being considered, some senate staff working on the bill specifically acknowledged that Dodd-Frank did *not* qualify for an above-the-line deduction. See Letter by Harold R. Burke to Mary Schapiro, Chairwoman, Securities and Exchange Commission (Sept. 14, 2010). Moreover, a former SEC Senior Counsel similarly suggested in 2013 that Dodd-Frank does not qualify under this above-the-line deduction. See Gary Aguirre, "Unfair Tax Liability for Whistleblower Awards under Dodd-Frank," Government Accountability Project (Apr. 11, 2013).

To an SEC whistleblower, this may not be conclusive, but it is sure worrisome. Of course, there can sometimes be an overlap. For example, whistleblower claims often arise out of employment. In my experience, many SEC whistleblowers were employed by the firms whose conduct they reported.

There is also an awfully broad "catch-all" provision of I.R.C. Section 62(e)(18). That provision provides that a claim of unlawful discrimination includes a claim under any provision of state law "regulating any aspect of the employment relationship including . . . [any provision] *prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.*" I.R.C. § 62(e)(18)(ii) (emphasis added); see Robert W. Wood, *Tax Aspects of Settlements and Judgments*, 522 T.M., Part V.G.1., A-63 (2015).

This language in I.R.C. Section 62(e)(18) is nearly identical to the language in I.R.C. Section 62(e)(17). I.R.C. Section 62(e)(17) provides that legal fees for suits involving claims of retaliation against whistleblowers in violation of *any* federal whistleblower protection laws can qualify for the above-the-line deduction. The SEC whistleblower rules contain robust whistleblower protections against employment retaliation. See Dodd-Frank Act § 922(h), *codified as* 15 U.S.C. § 78u-6(h).

The SEC whistleblower protections created by the Dodd-Frank Act allow SEC whistleblowers who have been retaliated against other remedies, too. They may be entitled to reinstatement; double back-pay, with interest; and compensation for their legal expenses and attorney's fees. In fact, if an SEC whistleblower has been retaliated against, there is a strong argument that they can deduct their legal fees above the line.

However, it is less clear whether an SEC whistleblower who has *not* been retaliated against can qualify for the above-the-line deduction. If such a line can be drawn, the public-policy implications seem odd. After all, Congress surely hoped to create every

incentive possible for SEC whistleblowers to come forward.

Indeed, retaliation is expressly discouraged. It seems perverse to create incentives for whistleblowers to try to *prompt* retaliation against them (or to allege retaliation that did not occur) to qualify for an above-the-line deduction. Nevertheless, under the current law, whistleblowers bringing suit might understandably cross their fingers in hopes of at least *some* measure of retaliation. Paradoxically, retaliation might be good if it is the ticket to claiming an above-the-line tax deduction.

### 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 I.R.C. Section 62(a)(20). One might make the same observation about an SEC whistleblower's claim of retaliation, however minor that retaliation might be.

However, knowing the IRS, you might reasonably assume that there 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, assume you have a tax-free, physical injury recovery, but 50 percent of the damages are punitive. With damages that are 50 percent tax-free and 50 percent taxable, the legal fees must be divided, too. One generally treats 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 the tax-free portion in income and try to deduct it. 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 usually means a miscellaneous itemized deduction, which is treated unfavorably. One potential answer 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, suppose that 90 percent of the lawyer's time in the case was devoted to compensatory damages, with only 10 percent to punitive damages. If lawyer bills and declarations support that, it could mean large tax savings. Anything better than 50/50 might help.

### Allocating SEC Claims

With this background, should legal fees in SEC and other whistleblower recoveries be allocated in some way? Assume an SEC whistleblower collects $10 million, allocated as follows: 90 percent from the target's bad conduct exposed in the claim, and 10 percent for relation against the employee-whistleblower. Does this suggest an above-the-line deduction for 10 percent of the legal fees, and a miscellaneous itemized deduction for 90 percent of the fees?

It should not, in my opinion. I worried about this issue in 2004 when the above-the-line deduction was enacted. See Robert W. Wood, "Jobs Act Attorney Fee Provision: Is it Enough?," 105 Tax Notes 8, 961 (Nov. 15, 2004). However, I have seen no suggestion since then that the IRS would require it. I have also not encountered other practitioners who seem worried about it. Where one claim qualifies for an above-the-line deduction under I.R.C. Section 62(a)(20), I think it is likely that *all* legal fees allocable to taxable recoveries can be deducted above the line. See also Robert W. Wood, *Tax Aspects of Settlements and Judgments,* 522 T.M, Part V.G.2., A-64 (2015).

The IRS has provided at least one indication that it might agree. In Chief Counsel Memorandum 20133501F (Aug. 30, 2013), the IRS described I.R.C. 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, this language seems to suggest a liberal application of I.R.C. Section 62(e)(18) for actions where at least *one* claim involves the employment relationship.

More generally, 13 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 liberally, which seems to me to be entirely appropriate.

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. It is true that SEC whistleblower claims might be viewed differently, given the statute, but hopefully they will not be.

### Deductibility Limits

One detail of the above-the-line deduction that is easy to miss relates to gross income. Normally, a cash-basis taxpayer is eligible to claim a deduction in the year the underlying payment was made. See I.R.C. § 461(a); Treas. Reg. § 1.461-1(a)(1). However, I.R.C. Section 62(a)(20) limits the available deduction to the income derived from the underlying claim in the same tax year. As a result, 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, where there is a mixture of hourly and contingent fees, the issues can be thorny and may require professional help.

### Trade or Business

Before leaving above-the-line versus below-the-line deductions, it is appropriate to consider an additional way that taxpayers may qualify for above-the-line deductions. A taxpayer operating a trade or business and incurring legal fees—contingent or otherwise—need not worry about these issues. In a corporation, LLC, 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. This may sound silly in the case of plaintiffs in employment cases. That is where

the argument first appears to have surfaced (long before the above-the-line deduction was enacted in 2004). See, e.g., *Alexander v. Comm'r*, 72 F.3d 938 (1st Cir. 1995). However, it is quite credible in the case of some serial whistleblowers.

Some file multiple claims, and some go on the lecture circuit, especially after their claims bear fruit. Thus, there is a distinct possibility that a whistleblower can, in a very real sense, be operating a business. A proprietor—a taxpayer operating a business without a legal entity—reports income and loss on Schedule C to his or her Form 1040.

To be sure, you are not likely to want to make a Schedule C argument if you have a good argument for a statutory above-the-line deduction. Schedule C to a Form 1040 tax return is historically more likely to be audited than virtually any other return, or portion of a return. In part, this is due to the hobby-loss phenomenon, with expenses usually exceeding income. It is also due to self-employment taxes. Placing income on a Schedule C normally means self-employment income, and the extra tax hit on that alone can be 15.3 percent. Over the wage base, of course, the rate drops to 2.9 percent.

Even so, most whistleblowers and plaintiffs do not want to add self-employment tax to the taxes they are *already* paying. Still, when it comes to deducting legal fees, the Schedule C at least deserves a mention. Plaintiffs or whistleblowers who have been regularly filing Schedule C for business activities in the past stand a better chance of prevailing with their Schedule C.

## Conclusion

Long before and shortly after the Supreme Court's *Banks* case in 2005, there was considerable discussion about the tax treatment of legal fees. Plaintiffs' employment lawyers were especially vocal in the years leading up to 2004, and they were particularly effective in lobbying Congress. That led to the statutory change in 2004, which ended up covering *some* whistleblower claims, too.

In part, the statutory changes in late 2004 blunted the impact of the *Banks* case, which even the Supreme Court itself noted in its opinion. Yet vast number of plaintiffs—and some whistleblowers—are still stuck with the dilemma of how to deduct their legal fees. In the case of SEC whistleblower claims, some people seem to assume that the above-the-line deduction surely *must* apply. Some people say it does not—not *technically.* Some seem to ignore the issue entirely. Given the dollars that are often involved, however, it would be wise to consider the income and deduction side of legal fees and costs. A large number of successful plaintiffs and some whistleblowers end up surprised at tax time. As more SEC whistleblower claims are paid, there will hopefully be no successful whistleblowers surprised by their tax preparer, or worse still, by the IRS.

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