Will the IRS and Tax Court Restrict Tax Deductions for Legal Fees?

by Robert W. Wood

Successful plaintiffs invariably want to know how they will be taxed. Is it tax free, ordinary income, wages, basis recovery, capital gain, or some combination? Among the issues plaintiffs find hardest to understand is how they could be taxed on attorney fees they never receive.

The facts often go something like this: Plaintiff settles for $1 million, and Plaintiff’s contingent fee lawyer receives the funds, deducts his 40 percent, and remits $600,000 to Plaintiff. Plaintiff’s understandable reaction is that his tax problem is limited to $600,000. He thinks, “The $400,000 simply isn’t income because I never received it!”

Plaintiff may be able to get past the fact that the $400,000 is gross income. Then, Plaintiff will be even more upset if there is not a reliable way to completely deduct the $400,000. That is where our story begins. Let’s start with the easy cases in which there should be no problem.

The bigger the recovery, and the larger the attorney fees and costs, the worse the tax result. Some- times there are multiple sets of lawyers, with fees and costs as high as 70 percent of the total. With only a miscellaneous itemized deduction, as the Supreme Court noted in Banks, there are situations

Taxable and Partially Taxable Recoveries

With recoveries that are wholly or partially taxable, how attorney fees are deducted can be a problem. In Banks, the Supreme Court held that plaintiffs are generally treated as receiving 100 percent of their settlements and judgments. That is true even if their lawyers receive the settlement funds, deduct the contingent fees to which the lawyers are entitled, and pay their clients the balance.

The plaintiff will generally be taxed on his net recovery only if the fees can be deducted above the line. In 2004, Congress added section 62(a)(20), allowing an above-the-line deduction for some legal fees:

Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination (as defined in subsection (e) or a claim of a violation of subchapter III of chapter 37 of title 31, United States code or a claim made under section 1862(b)(3)(A) of the Social Security Act (42 U.S.C. 1395y(b)(3)(A)).

That law primarily covers employment cases and whistleblower claims. The provision avoids treating the fees as miscellaneous itemized deductions, subject to the 2 percent threshold, phaseouts, and alternative minimum tax rules. This can occur even in catastrophic physical injury cases.

Even if the origin of the case is a catastrophic physical injury or wrongful death, the presence of punitive damages or interest can require an allocation. The portion of the recovery that constitutes punitive damages or interest remains taxable. If a recovery is taxable, the gross amount, including the legal fees attributable to that portion of the recovery, is taxable.


3 Section 62(e) sets out qualifying discrimination claims.
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in which the tax on the gross recovery exceeds the net recovery received by the taxpayer. It can create “the perverse result that the plaintiff loses money by winning the suit.”

Above-the-Line Deduction

Almost any claim in the employment context, including a whistleblower claim, is covered by the 62(a)(20) deduction. Among other things, under section 62(e)(18), the statute permits the deduction from gross income of attorney fees regarding claims “providing for the enforcement of civil rights, or...regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or 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.”

Structurally, section 62(e)(18) is a catchall provision, intended to benefit even claims of unlawful discrimination that are not otherwise specifically listed in that section. In FFA 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). Any, presumably, means any.

Similarly, LTR 200550004 involved a suit for pension payments under section 502(a)(3) of ERISA. Applying section 62(e)(18), the IRS reasoned that the money to be received by the taxpayer “resolves a claim for pension benefits that [the taxpayer] asserted against [its] employer under federal law. Thus, the ... award resolves a claim of unlawful discrimination under [section] 62(e).” The fact that this was a claim for pension payments was sufficient.

Of course, many claims still fall entirely outside the scope of the above-the-line deduction. Examples outside the employment context include claims for defamation, infliction of emotional distress, contract disputes, and property disputes. If such claims are made in the context of employment or involve civil rights, the fees may be deductible above the line.

Otherwise, the legal fees may be considered miscellaneous itemized deductions. When employment claims or violations of civil rights are part of the case, the IRS generally seems to approve all the fees as an above-the-line deduction. In general, the IRS has not pushed to bifurcate the legal fees and to allocate them based on which claims truly involve employment or civil rights, and which do not. That stands as a welcome contrast to some other areas in which legal fees are bifurcated and treated as non-deductible, deductible, or subject to capitalization based on some kind of allocation.

Sas

In Sas, the Tax Court held that the legal fees in question paid by Ellen Sas and her husband, Roger Jones, did not qualify for the above-the-line deduction and could only be treated as miscellaneous itemized deductions. The court found that they were insufficiently employment-related. Moreover, they did not qualify as business expenses, which had been the taxpayers’ alternative argument. Although it is only a summary opinion from the Tax Court, it is a troubling example of both the IRS and the Tax Court restricting the provision.

In 2008 Seattle Bank hired Sas as president and CEO. In mid-2010, she received a change-of-control bonus of $612,000. Sas and her spouse would later report the bonus as wages on their joint 2010 tax return. However, a few months after receiving the bonus, Seattle Bank terminated Sas’s employment. A few months later, Seattle Bank filed suit against Sas, alleging breach of fiduciary duty, and attempted to recover the $612,000 bonus. Sas counterclaimed, alleging employment discrimination. The parties settled in mid-2011. The settlement agreement provided that Seattle Bank and Sas would each pay nothing, and each released all claims against the other.

Sas paid $25,000 to her lawyer in 2010, and another $55,798 in 2011. She and her husband also maintained an accounting and consulting business, with Jones reporting on their joint Schedule C. For 2011, they had no income on Schedule C, and $293,385 of income on Schedule E, “Supplemental Income and Loss.”

On their 2010 joint return, in addition to the $612,000 bonus, they reported a negative $25,000 of income on the “other income” line (line 21) of their return to claim the legal fees. They claimed the same line 21 treatment for 2011, deducting the $55,798. The IRS disallowed both, but allowed them as miscellaneous itemized deductions for each year.

7Summary opinions are issued under the Tax Court’s small case procedures. A summary opinion cannot be relied on as precedent, and the decision cannot be appealed. See Tax Court, “Taxpayer Information: After Trial.” Congress mandated that summary opinions “not be treated as precedent in any other case.” Under section 7463(b), the Tax Court cannot make precedent in a small case, nor can any court treat a summary opinion as precedent. Andy Grewal, “The Un-Precedented Tax Court: Summary Opinions” (May 29, 2015).

4Banks, supra note 1.
Eventually, the taxpayers went to Tax Court. Predictably, they argued that these were employment-related legal fees and therefore deductible above the line. Also, they argued that they were ordinary and necessary business expenses for their Schedule C accounting and consulting business. They argued that the lawsuit would have an adverse effect on Sas’s professional reputation, which could harm their accounting business.

Employment Dispute?

Despite the seeming breadth of the above-the-line deduction, the Tax Court held that these legal fees only qualified as miscellaneous itemized deductions. In one sense, the decision is understandable, because this was not your usual employment settlement. Normally, the plaintiff recovers from the employer, and one can subtract the legal fees without going negative.

Here, of course, there was a walkaway settlement, so there was no additional gross income to Sas. However, Sas sensibly argued that the whole dispute was about her bonus. After all, that was what the employer was trying to get back. She argued that she had included the bonus as income when she received it in 2010.

Indeed, she was only able to retain it because of her counterclaims. Therefore, she argued, the legal expenses were directly related to the case and that $612,000. That seemed fairly persuasive. Nevertheless, the Tax Court concluded that the “amount includible in the taxpayer’s gross income” cannot reasonably be interpreted to include prevention of potential loss of income that would be includible in the absence of any claim.

The Tax Court found that Sas’s bonus was related to her employment. In fact, the court noted that the settlement agreement stated explicitly that neither party was being paid. That raises the question whether the tax result might have been different if the settlement agreement had been more carefully drafted to address this point.

In any case, the court observed that there was a gross income provision in the statute. That is, the legal expenses could be deducted above the line only if the case produces gross income in the same tax year from which to deduct it. Because the court said her bonus was unrelated, there was no gross income. The court did not expressly hold that the legal fees were not employment-related.

However, the court said that it would assume for argument’s sake that her counterclaims were in connection with unlawful discrimination. Even so, both amounts of legal fees were in excess of any gross income she got from the case. So the court would not allow any above-the-line deduction.

Business Expense?

Next, the Tax Court took on Sas’s argument about her professional reputation. The court acknowledged that the clawback of Sas’s bonus could harm her professional reputation, which could harm the accounting business. However, the court said the origin of the claim was what mattered, not the potential consequences of a win or loss.

The court found that Sas’s claims arose from her status as a former employee of Seattle Bank, not from the taxpayers’ accounting business. Indeed, Sas hired an attorney because Seattle Bank was attempting to claw back a bonus. That meant these legal fees were plain old miscellaneous itemized deductions, nothing more.

The court even referred to Gilmore. In Gilmore, a divorce case, Don Gilmore’s wife was claiming over half of his stock in his three General Motors dealership franchises. He fought her claims, and his legal fees were high.

Gilmore deducted the legal fees as business expenses, noting that if his wife had won, he could have lost his job as the president and general manager of the three dealerships. Indeed, GM could well have canceled his dealer franchise. The Supreme Court ruled that the tax character of the costs of resisting a claim depended on whether the claim arises in connection with the taxpayer’s profit-seeking activities. The consequences were different. Because the origin and character of the taxpayer’s claim were personal (Gilmore’s divorce), his legal expenses were not deductible. The Tax Court in Sas also relied on a more recent case.

In Test, the taxpayer was employed by the University of California. In addition to her university employment, she owned a business. When her university department was under a state audit, she hired counsel to respond to negative publicity, and to attempt to prevent the public release of the audit report draft.

She deducted the legal fees as a business expense, claiming that she was protecting her professional reputation. That, in turn, was important to the success of her side business. The Tax Court held that the legal expense originated in her employment at the university, not with the operation of her own company. That meant the legal fees could not

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8Section 62(a)(20) (“The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer’s gross income for the taxable year on account of a judgment or settlement . . . resulting from such claim.”).


10Test v. Commissioner, T.C. Memo. 2000-362, aff’d, 49 Fed. Appx. 96 (9th Cir. 2002).
be claimed as business deductions on Schedule C, but only as miscellaneous itemized deductions.\textsuperscript{11}

Conclusion
No one wants to pay taxes on money they do not see. No one wants to be stuck with miscellaneous itemized deduction treatment for legal fees if they can avoid it. For businesses, business expense treatment causes few problems. But some plaintiffs still struggle.

It has been 13 years since Congress enacted the above-the-line deduction. For most employment and many whistleblower claims, it prevents negative results. But not for everyone. For example, some employment claims are handled with hourly lawyers.

In that event, the plaintiff would likely pay ongoing legal fees and would like to deduct them. But without offsetting gross income from the case in the same tax year to claim an above-the-line deduction, the plaintiff is stuck with a miscellaneous itemized one. And that is only one example.

Several types of whistleblower claims are not expressly covered by the statute. And of course, there are vast numbers of non-employment and non-whistleblower claims. Some plaintiffs do not realize they are getting a miscellaneous itemized deduction until tax return time. In that sense, perhaps we are due for another legislative fix, this time perhaps a more complete one?

\textsuperscript{11}Test was decided before section 62(a)(20) was enacted in 2004. Accordingly, it does not address whether the taxpayer could deduct the legal fees above the line as fees for an employment claim.