Whistleblowers Face Self-Employment Tax Worries Too

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In this article, Wood and Roberts explore new concerns that whistleblowers for the SEC and other agencies may face self-employment taxes on their recoveries.

This discussion is not intended as legal advice.

For over a century, the federal government has awarded whistleblowers money for information related to wrongdoing. The first federal whistleblower statute, the False Claims Act (FCA), was enacted in 1863, and stemmed from concerns that suppliers for the Union Army were submitting false claims to the government.[1] Since then, the federal government has significantly expanded its whistleblower programs.

Today, whistleblowers can submit claims to the government based on commodity and federal securities violations and even on a person's failure to pay federal income taxes.[2] States, too, have their own statutes governing whistleblower claims.[3] To entice whistleblowers to come forward, governments pay them handsomely if their tips lead to successful recoveries.

For example, under the FCA, a whistleblower can receive between 15 and 30 percent of the amount the government collects related to the false or fraudulent activity identified by the whistleblower.[4] Other federal and state whistleblower statutes offer similar percentage-of-recovery based awards.[5] Generally, the percentage awarded depends on the whistleblowers' level of participation in the claims and the information they provide.[6]

Thus, whistleblowers who expend significant effort in advancing the government's interests are often paid a larger percentage of the recovery than those who do not. Similarly, the quality of the information the whistleblower provides can affect the award under some statutes. The SEC alone has

[1] Justice Department, "The False Claims Act: A Primer."

[2] *See* 7 U.S.C. section 26 (Commodity Futures Trading Commission whistleblower statute); 15 U.S.C. section 78u-6 (SEC whistleblower statute); section 7623 (IRS whistleblower program).

[3] Cal. Code section 12650 et seq. (California False Claims Act); New York State Finance Law, art. 13, section 187 (New York False Claims Act).

[4] 31 U.S.C. section 3730(d).

[5] *See supra* notes 2 and 3.

[6] 31 U.S.C. section 3730(d) ("depending upon the extent to which the person substantially contributed to the prosecution of the action"); section 7623(a) ("The determination of the amount of such award by the Whistleblower Office shall depend upon the extent to which the individual substantially contributed to such action."); 17 C.F.R. section 2401.21F-6(a) (SEC will consider significance of information and assistance provided by the whistleblower in determining award).

awarded more than $300 million to whistleblowers since the program began in 2011.[7] As with other federal whistleblower programs, some of these awards have ranged in the tens of millions.[8]

Legal Fees

Whistleblowers worry about taxes and want to be certain they are paying tax only on their net recoveries, not their gross recoveries. Historically, this has not always been easy. Before 2004 many whistleblowers realized gross income on 100 percent of their awards and had to claim a miscellaneous itemized deduction for their legal fees. With percentage limits, phaseouts, and alternative minimum tax, that usually came to half a loaf.

But the law evolved between 2004 and 2019, so whistleblowers now can claim an above-the-line deduction for their fees. SEC and Commodity Futures Trading Commission claims finally qualified for the deduction in 2018. A deduction for fees is essential, because the Supreme Court's *Banks*[9] decision says 100 percent of the gross award is the client's income, even if the lawyer deducts a fee and pays the client only the net amount.

Some whistleblowers have argued that an award is for information and analogous to an intellectual property transaction. As a payment for what is typically trade secret type information, shouldn't this be a capital gain? This is not a spurious argument.

So far, however, several federal circuit courts have held that FCA whistleblower awards (at least) are subject to federal income tax at ordinary income tax rates.[10] An SEC or CFTC award might present different arguments. In any case, the above-the-line deduction should generally mean that only the net figure is taxed.

As it turns out, however, there may be an additional layer of federal tax lurking: the self-employment tax. If you collect a seven- or eight-figure award, you may be very happy. But if you later find you must pay self-employment tax on it, you may be less so.

Self-Employment Tax and Forms 1099

If you asked most whistleblowers if they are self-employed, they would say no. Many, if not most, make claims while they are employees working for the target of their claims. The self-employment tax applies to income derived from a trade or business. Whether a taxpayer is engaged in a trade or business has been a hotly contested issue — but it may seem odd to even consider it here.

Many "is this a trade or business" queries arise when the taxpayer argues that it is and the IRS says it is not. Think hobby loss cases. The incentives are obvious when taxpayers are trying to deduct expenses as ordinary and necessary business expenses under section 162. No one wants to be limited to the hobby loss rules under section 183.

Unfortunately, and as discussed more fully later, whether a whistleblower's activities constitute a trade or business is also murky and not necessarily straightforward. If the whistleblower or his tax adviser have not even thought about self-employment tax, the issue may first arise upon receipt of a Form 1099-MISC reporting the whistleblower award. We have seen these awards reported in box 7 as nonemployee compensation. We have also seen awards reported in box 3 as other income.

In some cases, we have even seen the government agency issue more than one Form 1099-MISC for the same award, waffling between reporting in boxes 7 and 3. The SEC notably did that for 2018 recoveries, evidently deciding that box 7 was better. But is it? And how can the SEC even know that this is really nonemployee compensation versus other income?

For federal tax reporting purposes, the distinction between boxes 7 and 3 can be significant. Generally, amounts reflected in box 7 are reported on Schedule C. If the Schedule C shows a net profit, that net profit is subject to self-

[7] SEC, "Whistleblower Awards Over $300 Million for Tips Resulting in Enforcement Actions" (Aug. 23, 2019).

[8] SEC release, "SEC Announces Its Largest-Ever Whistleblower Awards" (Mar. 19, 2018).

[9] *Commissioner v. Banks*, 543 U.S. 426 (2005).

[10] *Alderson v. United States*, 686 F.3d 791 (9th Cir. 2012); *Campbell v. Commissioner*, 658 F.3d 1255 (11th Cir. 2011); *Patrick v. Commissioner*, 799 F.3d 885 (7th Cir. 2015).

employment taxes. If you are conducting a trade or business, that seems appropriate.

Amounts reflected in box 3 of Form 1099-MISC are generally reported in an entirely different part of the tax return. Before 2018, they went on line 21 of Form 1040. Now, they are reported on Schedule 1 of the tax return as other income. Unlike Schedule C net profits, other income is not subject to self-employment taxes.

Taxpayers and tax professionals alike can be forgiven for having a knee-jerk reaction about box 3 versus box 7. Doesn't that choice dictate the tax treatment in all cases? No, it does not. The reporting of the whistleblower award in either box does not govern how the award should be treated for federal tax purposes. In fact, the IRS has recognized in the Form 1099-MISC instructions that a taxpayer should report box 7 income on Schedule C only if the amount represents self-employment income.[11]

How do you know? We'll come back to that question. The instructions further advise the taxpayer to report box 7 income as other income if the payment does not represent self-employment income, such as income from a sporadic activity or hobby.[12] In other guidance, the IRS has noted that a taxpayer is not required to report box 7 income on Schedule C unless the income was derived from a "self-employed trade or business."[13]

Federal courts agree on this issue. They have held that the facts and circumstances surrounding the payment, and not the reporting box on the Form 1099-MISC, govern whether the payment is subject to self-employment tax.[14]

Federal Self-Employment Tax

The tax code imposes three different taxes on an individual's self-employment income: a 12.4 percent Social Security tax, a 2.9 percent Medicare tax, and a 0.9 percent Medicare surcharge tax.[15] For 2019 the Social Security tax applies to self-employment income up to $132,900.[16] The Medicare tax is imposed on all of an individual's self-employment income (there is no ceiling as with the Social Security tax), and the Medicare surcharge tax is imposed on self-employment income exceeding $200,000, or in the case of a joint return, $250,000 (the Medicare surcharge floors).[17]

Collectively, these three taxes are commonly referred to as self-employment taxes. However, for an individual to be subject to self-employment taxes, the income derived from the activity must represent income from a trade or business.[18] For these purposes, the term "trade or business" has the same meaning as it has when used in section 162 (regarding trade or business expenses), and does not include an individual's performance of services as an employee.[19]

Federal courts and the IRS have examined the facts and circumstances to determine whether a taxpayer is engaged in a trade or business. For purposes of section 162, courts have considered whether the taxpayer: (1) has been "involved in the activity with continuity and regularity,"[20] (2) devotes "sufficient time over a substantial enough period,"[21] and (3) holds himself out as being engaged in selling goods or services.[22]

The *Bagley* Decision

At least one federal court has held that an individual's activities as a whistleblower can rise to the level of a trade or business. It is mostly an unfortunate decision, and it could hurt some passive whistleblowers who clearly are not running a business. In *Bagley*,[23] the taxpayer filed a *qui tam* lawsuit against his former employer under the FCA.

Bagley's FCA lawsuits were successful, and he received a large whistleblower award. At tax time,

[11] Form 1099-MISC, Instructions for Recipient. *See also* Robert W. Wood and Dashiell C. Shapiro, "Blowing the Whistle on Taxing Whistleblower Recoveries," *Tax Notes*, Dec. 2, 2013, p. 983.

[12] Form 1099-MISC, Instructions for Recipient.

[13] IRS, "Frequently Asked Questions."

[14] *Spiegelman v. Commissioner*, 102 T.C. 394 (1994); *Batok v. Commissioner*, T.C. Memo. 1992-727.

[15] Section 1401.

[16] Social Security Administration, "Contribution and Benefit Base."

[17] Section 1401(b)(1) and (2).

[18] Section 1402.

[19] Section 1402(c).

[20] *Commissioner v. Groetzinger*, 480 U.S. 23 at 35 (1987); *see also Green v. Commissioner*, 74 T.C. 1229, 1235 (1980) (Taxpayer "actively engaged" in the "continual and regular process" of selling blood plasma.).

[21] *Snyder v. United States*, 674 F.2d 1359, 1364 (10th Cir. 1982).

[22] *Green v. Commissioner*, 83 T.C. 667, 686 (1984).

[23] *Bagley v. United States*, 936 F. Supp. 2d 982 (C.D. Cal. 2013).

Bagley recognized he had a problem: The Justice Department had issued him a Form 1099-MISC with the FCA whistleblower award reported in box 3 as other income. Also, during the tax year at issue, the IRC did not specifically provide for an above-the-line deduction for attorney fees related to FCA lawsuits.[24]

Rather, the code permitted only a below-the-line deduction for attorney fees, which were subject to various restrictions, including AMT, unless the taxpayer was able to show that the attorney fees related to a trade or business and were deductible under section 162. "Aha," thought Bagley, "I have an idea." Bagley originally reported the FCA whistleblower award as other income and the attorney fees as below-the-line deductions on Schedule A.

He later amended his return. In his amended return, Bagley reported the award and the attorney fees on Schedule C. The Schedule C idea for deducting legal fees was in vogue at one time, before the above-the-line deduction for legal fees was enacted in 2004. Even employment plaintiffs tried it.

"This lawsuit is essentially a trade or business," went the argument. But it usually failed.[25] On amending his return, Bagley asked for a substantial refund, but the IRS pushed back. At trial, Bagley argued that the attorney fees were deductible under section 162. He contended they were deductible because he had a profit motive in conducting his FCA activities. Plus, he engaged in those activities continually and regularly. The government argued, conversely, that Bagley was not engaged in a trade or business.

Profit Motive

The court held that Bagley had the requisite profit motive while investigating and prosecuting his FCA claims. In analyzing Bagley's profit motive, the court sought guidance from the regulations under section 183, which seek to distinguish between hobby-type activities (subject to limitations on deductions) and trade or business-type activities (generally deductible under section 162).[26]

The regulations provide a list of relevant factors in determining whether an activity is engaged in for profit. They caution that "all facts and circumstances with respect to the activity are to be taken into account . . . [and] no one factor is determinative in making this determination." In reviewing those factors, the court concluded that most of the factors favored Bagley. Specifically, the court noted that Bagley: (1) spent considerable time on the FCA activities; (2) maintained contemporaneous time logs regarding the FCA activities; (3) was an expert in the subject matter of the FCA violations; (4) was not employed during the FCA litigation; and (5) gained no personal recreation or pleasure from the activities.

The court also looked to Bagley's attorneys' time and experience, presumably under a theory of agency. Thus, all the time spent by Bagley's attorneys on the FCA lawsuit was attributable to Bagley, in addition to the extensive experience the attorneys had in prior FCA lawsuits. Both facts helped Bagley establish a profit motive.

Regular and Continuous

In *Bagley*, the court reasoned that having a profit motive alone was not sufficient to constitute a trade or business. Instead, the court found that Bagley was also required to show that he devoted "a substantial period of time to the activities" or "extensive or repeated activity over a substantial period of time." Relying on the Supreme Court's decision in *Groetzinger*,[27] the court further concluded that Bagley was required to show that he engaged in the activity "full time, in good faith, and with regularity" and with a necessary degree of skill applied to the activity.

The court found that Bagley met these requirements. Specifically, the court found that it was "indisputable" that his activities occurred over a substantial period, and that he had devoted much of his time and energy to the tasks and responsibilities of investigating and litigating the FCA lawsuits. These tasks and responsibilities included: (1) attending regular meetings; (2)

[24] The tax year at issue was 2003. In 2004 Congress added an above-the-line deduction for attorney fees, which included any claims under the FCA.

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

[26] Reg. section 1.183-2(b).

[27] *Groetzinger*, 480 U.S. 23.

reviewing documents; (3) creating and revising court documents, including court filings; (4) preparing damage calculations; and (5) assisting his attorneys and the government in understanding the nature of the FCA claims, in addition to identifying documents and witnesses necessary to effectively litigate the case.

Lessons From *Bagley*?

As *Bagley* shows, a whistleblower's profit motive and degree of participation can rise to the level of a trade or business on the right facts. This inquiry is inherently factual and often difficult to assess. In the typical whistleblower case, there will always be some element of profit motive. But just how regular and continuous it is, what else the whistleblower is doing, and how much the whistleblower's counsel is doing, are going to vary quite a lot.

Speaking of the whistleblower's counsel, who is the taxpayer's agent, is *all* of that activity attributed to the whistleblower? The *Bagley* court seemed to think so. Thus, counsel's participation in the whistleblower activity, on the right set of facts, could cause the IRS to be even more inclined to characterize a whistleblower's activities as a trade or business.

Generally, whistleblowers submit their claims under the whistleblower program with the hope that it will result in a significant monetary award. However, *Bagley* shows that courts will dig deeper for profit motive by looking at the relevant factors under the section 183 regulations. *Bagley* also shows that a whistleblower's activities in the whistleblower program are significant in determining whether he is in a trade or business.

This can present some thorny tax issues. The whistleblower statutes are generally geared to reward more active participants with higher percentage awards. Moreover, many programs require whistleblowers to submit position papers on their level of participation to assist the government agency in determining the appropriate award. Not surprisingly, whistleblowers have a natural incentive to contend that they participated heavily in the whistleblower claim to receive the maximum percentage award. These statements could backfire when tax time arrives.

Conclusions

Whistleblowers and their tax advisers should carefully review the whistleblower's facts and circumstances to determine whether the whistleblower should be subject to federal self-employment tax. Most whistleblowers are unlikely to want to voluntarily pay it if they were employed, made the claim on the side, and did not become a serial whistleblower on the lecture circuit. Indeed, even some whistleblowers who might look pretty self-employed might hope not to pay self-employment tax.

Particularly with box 7 reporting, even whistleblowers who insist that they could never be viewed as self-employed might want to start lining up their arguments. Given the dynamics, we should expect these issues to arise. That is particularly so, given the SEC's box 7 reporting position.

Some whistleblowers who did not report self-employment tax are already receiving IRS notices. Please pay the self-employment tax, the notices say. Unfortunately, determining whether the tax should apply is not always easy and is rarely black or white.

Rather, one needs a thorough analysis of facts, the regulations under section 183, and the degree of participation provided by the whistleblower during the claim. Given the decision in *Bagley*, a cautious whistleblower might expect the IRS to challenge a blanket assertion that she is not engaged in a trade or business merely because she is a whistleblower. The IRS's loss in *Bagley* could even mean a few victories for the agency on self-employment tax. ■