# SEC Whistleblower Claims Face Legal Fee Deduction Hurdles

**by Robert W. Wood**

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In this article, Wood discusses different types of whistleblower claims as well as when and how legal fees can be deducted for plaintiffs whose claims were successful.

This discussion is not legal advice.



Whistleblower claims are brought under various federal and state statutes, and they are usually handled for contingent fees. Some of these cases are small, but some involve tens of millions of dollars. For 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 big issue. Most plaintiffs and whistleblowers assume that the most that could be taxable to them by the IRS (or by their state) is their net recovery from the case. Plaintiffs and whistleblowers might see only that amount because lawyers often receive the gross amount, deduct their fees, and remit only the balance to the plaintiff or whistleblower. But their net take-home pay after legal fees and costs is not the only money the IRS knows of. For many plaintiffs and whistleblowers, the first inkling that the gross recovery may be considered their income is the arrival of Forms 1099 in January. The specter of additional taxes can be an unpleasant surprise to the claimants and their lawyers.

The statute under which the claim is made can materially affect taxes. The oldest whistleblower statute is the federal False Claims Act,[1] dating to the Civil War. But there are state versions of this law as well as IRS whistleblower claims and SEC whistleblower claims. The latter emanate from section 922 of the Dodd-Frank Act.[2]

To say that not all whistleblower claims are created equal when it comes to taxes would be an understatement. Some claims clearly qualify to have legal fees deductible above-the-line. For other claims, it is either not so clear, or they clearly do not qualify.

The bigger the numbers, the bigger the potential tax problem: If you obtain a huge recovery and must pay 40 percent or more to your lawyer, for example, you will care very much about the type of deduction you receive for those fees.

## Client Relations 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 includible in the income of the plaintiff, even if they were paid directly to the plaintiff's attorney by the defendant.[3] For tax purposes, the plaintiff is considered the recipient of the gross award, including any portion that goes to pay legal fees and costs.

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

[2] P.L. No. 111-203, 124 Stat. 1377 (July 21, 2010).

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

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 him. The client should receive one, too, also for 100 percent.

The lawyer's Form 1099 may be for gross proceeds, with the amount included in Box 14 of Form 1099-MISC. Lawyers should note that this is the best reporting for the lawyer. Money paid to a lawyer and reported as gross proceeds 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 (also) 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 whistleblower has that amount of gross income. When you receive a Form 1099 reporting income in box 3 or box 7, 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.

In many other contexts, plaintiffs receive Forms 1099, which they must explain. For example, plaintiffs who are seriously injured and should receive compensatory lawsuit proceeds tax-free for their physical injuries may still receive a Form 1099. In those cases, plaintiffs can report the amount on their tax return and explain why the Form 1099 they received was erroneous. They may note in their tax return that the payment was made because of personal physical injuries, so it should be excluded from their income under section 104.

Plaintiffs and whistleblowers obviously do not have that argument, because they are generally required to report the gross payment as their income. The question is how the plaintiff or whistleblower deducts the legal fees and costs. Plainly, they do not want to pay tax on the portion of their recoveries paid to their attorneys.

Successful whistleblowers might not mind paying tax on their *net* recoveries, but paying taxes on money their lawyers receive has long been controversial. Some readers may remember the tax controversies from the late 1980s that ran all the way up to 2005. Different courts around the country treated legal fees differently.

Some 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 gross income in the first place. In that happy event, there was no need to talk about tax deductions. Plaintiffs and whistleblowers understood being taxed on the net they received — and, frankly, it seemed to be common sense.

However, in *Banks*,[4] the Supreme Court resolved a bitter circuit court split about the tax treatment of attorney fees. The Court held — in general, at least — that the plaintiff has 100 percent of the income and must *somehow* deduct the legal fees. (The word "somehow" is important.)

In 2004, just months before the Supreme Court decided *Banks*, Congress added an above-the-line deduction for attorney fees, but only for some 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; the Worker Adjustment and Retraining Notification Act; 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 U.S. Code; and sections 1977, 1979, and 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

[4] *Id.*

employment relationship. Beyond that, a deduction for attorney fees and costs would be a miscellaneous itemized — that is, below-the-line — deduction under section 212. An above-the-line deduction is similar to an adjustment to income, so for all purposes, your adjusted gross income is reduced.

There is no haircut for 2 percent for an above-the-line deduction and no phase-out 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, as a matter of tax mathematics, is like not having the lawyer fee income in the first place. Once the client understands that despite the holding in *Banks*, they are really only taxed on their net, they are relieved.

In contrast, a below-the-line deduction faces all those limitations. It is aggregated with your other itemized deductions. The 2 percent threshold can really hurt, as can the phase-out that starts with surprisingly little income. These limits can cut deep: Think recoveries (and legal fees) in the millions.

Arguably, and worst of all, the AMT can mean no deduction. That is why, in some famous cases, "successful" plaintiffs have actually lost money after attorney fees and taxes.[5] 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 momentous.

## SEC Claims

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 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(a)(20), any action brought under the federal False Claims Act[6] is a claim of unlawful discrimination and can therefore qualify for an above-the-line deduction of legal fees.[7]

However, no part of section 62(a) or section 62(e) explicitly includes SEC whistleblower claims within the ambit of section 62. 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.[8] Moreover, in 2013, a former SEC senior counsel similarly suggested that Dodd-Frank does not qualify under section 62(a)(20).[9]

If you are a tax adviser, that information may not be conclusive, but it is 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 companies whose conduct they reported.

There is also a broad, "catch-all" provision of section 62(e)(18), which 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 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*" (emphasis added).[10]

This language in section 62(e)(18) is nearly identical to the language in section 62(e)(17). 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

[5] *Spina v. Forest Preserve Dist. of Cook County*, 207 F. Supp.2d 764 (N.D. Ill. 2002).

[6] 31 U.S.C. sections 3729-3733.

[7] Section 62(e)(17).

[8] *See* letter by Harold R. Burke to Mary Schapiro, Chairwoman, Securities and Exchange Commission (Sept. 14, 2010).

[9] *See* Gary Aguirre, "Unfair Tax Liability for Whistleblower Awards Under Dodd-Frank," Government Accountability Project (Apr. 11, 2013).

[10] Section 62(e)(18)(ii); *see* Robert W. Wood, "Tax Aspects of Settlements and Judgments," 522 T.M., Part V.G.1., A-63 (2015).

above-the-line deduction. The SEC whistleblower rules contain robust whistleblower protections against employment retaliation.[11]

The SEC whistleblower protections created by the Dodd-Frank Act allow other remedies for SEC whistleblowers who have been retaliated against. They may be entitled to reinstatement, double back pay with interest, and compensation for their legal expenses and attorney 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 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 deduction.

## Allocating Among Claims

The above-the-line deduction is available for any action "involving a claim of unlawful discrimination." But of course, many complaints allege multiple claims. Read literally, the language suggests that if *one* claim in a lawsuit qualifies as a claim of unlawful discrimination, *all* of the legal fees may be deducted under 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 would 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. 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. Therefore, if 50 percent of the damages are tax free, so are 50 percent of the legal fees.

That means there is no need to include the tax-free portion in income to 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 may have another allocation if you can support it. For example, suppose 90 percent of the lawyer time in the case was devoted to compensatory damages, with only 10 percent spent on punitive damages. If lawyer bills and declarations support that breakdown, it could mean large tax savings. Anything better than 50/50 might help.

## Allocating SEC Claims

Considering that background, then, should legal fees in SEC and other whistleblower recoveries be allocated in some way? Say, for example, 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 retaliation 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.[12] However, since then I have seen no suggestion that the IRS would require it. I have also not encountered other

[11] *See* Dodd-Frank Act section 922(h), codified as 15 U.S.C. section 78u-6(h).

[12] *See* Wood, "Jobs Act Attorney Fee Provision: Is it Enough?" *Tax Notes*, Nov. 15, 2004, p. 961.

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.[13]

The IRS has provided at least one indication that it would agree. In FAA 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, this 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, 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 concerns gross income. Typically, a cash-basis taxpayer is eligible to claim a deduction in the year the underlying payment was made.[14] 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 it occasionally can be. For example, when there is a mixture of hourly and contingent fees, the issues can be thorny and may require professional help.

### Trade or Business

Before leaving the topic of above-the-line versus below-the-line deductions, it is appropriate to consider another 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 proprietorship, business expenses are above-the-line deductions.

Some plaintiffs have even argued that they are in the "business" of suing people. This may sound silly in reference to plaintiffs in employment cases, which is where the argument first appears to have surfaced (long before the above-the-line deduction was enacted in 2004).[15] However, it is quite credible in the case of some serial whistleblowers.

Some whistleblowers file multiple claims, and some go on the lecture circuit, especially after their claims bear fruit. There is thus a distinct possibility that a whistleblower can, in a very real sense, be operating a business. A proprietor — that is, a taxpayer operating a business without a legal entity — reports income and loss on Schedule C to his 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, because Schedules C are historically more likely to be audited than almost any other return or portion of a return. In part, this is because of the hobby loss phenomenon in which expenses usually exceed income. It is also partly because of self-employment taxes: Placing income on a Schedule C usually means self-employment income, and the 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 deserves at least a mention. Plaintiffs or whistleblowers who

[13] *See also* Wood, "Tax Aspects of Settlements and Judgments," 522 T.M, Part V.G.2., A-64 (2015).

[14] Section 461(a); and reg. section 1.461-1(a)(1).

[15] *See, e.g., Alexander v. Commissioner*, 72 F.3d 938 (1st Cir. 1995).

have regularly filed Schedules 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 especially 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 the Supreme Court even noted in its opinion. Yet a vast number of plaintiffs — and some whistleblowers — are stuck with the dilemma of how to deduct their legal fees. For SEC whistleblower claims, some people seem to assume that the above-the-line deduction surely must apply.

Some people say it technically does not apply, and some seem to ignore the issue entirely. But given the dollars that are often involved, it would be wise to consider the income and deduction side of legal fees and costs. Before the 2004 statute changes, this issue received considerable attention — perhaps because employment plaintiffs felt especially hammered by the tax law.

Since 2004, employment plaintiffs and their lawyers largely have been silent. Meanwhile, many plaintiffs in other kinds of cases have ended up surprised at tax time. As more SEC whistleblower claims are paid, I hope no successful whistleblowers will be surprised by their tax preparer or, worse still, by the IRS. ■