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Individuals

Treatment of Legal Fees Incurred by Individuals

Depending on the claim that generated them, individuals' legal fees may be characterized in a variety of ways, from fully deductible to deductible only as a miscellaneous itemized deduction to totally nondeductible. This article explains the possible tax treatments, outlines how to determine the proper treatment, and highlights recent judicial and legislative developments.

Expenses are not tax deductible unless a specific provision in the Code allows their deduction. When an expense is connected with taxable income, taxpayers are highly motivated to find ways to deduct the expense. This is particularly true of legal fees because the income they are associated with might never have materialized without legal assistance, and the legal fees may be substantial.

Possible favorable treatments for deducting legal fees include either above-the-line deductions or adjustments to basis or selling price in a property transaction. However, legal fees incurred by individuals may also fall into less favorable categories: personal, nondeductible expenses or miscellaneous itemized deductions limited by the 2%-of-adjusted-gross-income (AGI) limit for regular tax and not allowed for alternative minimum tax (AMT) purposes.

The existence of less favorable deduction categories has led taxpayers to claim that their legal fees fall into the favorable categories or to describe the fees in such a way that they directly reduce the related income, thereby making deduction rules unimportant. Due to taxpayer efforts to get favorable tax treatment, complicated fact patterns, and lack of clarity in the law, there have been numerous court decisions on the treatment of legal fees incurred by individuals. This article explains the possible tax treatments of legal fees and how to determine the proper treatment. Several court decisions are used as examples, and recent developments in the area are explained. An analysis of how the current rules measure up under certain tax principles is also included.

General Rules

Code

Several Code provisions are relevant in determining the tax treatment of legal fees incurred by an individual. Sec. 162 allows ordinary and necessary expenses incurred in carrying on a trade or business. Sec. 212 provides a similar rule, but for the ordinary and necessary expenses incurred for income production or collection or for the management, conservation, or maintenance of property held for income production. In contrast, Sec. 262 denies deductions for personal, living, or family expenses.

Individuals have the added complication of determining if deductible expenses are deductible for AGI (above the line) or from AGI (below the line). The preferred treatment of deductions for AGI has led to much litigation. Sec. 62 treats expenses attributable to a trade or business carried on by an individual as deductible for AGI; however, this treatment does not apply to expenses arising from services performed as an employee. An exception to the employee rule allows above-the-line treatment for reimbursed employee expenses if paid under an arrangement for reimbursement or expense allowance (an accountable plan). Thus, legal fees not required to be capitalized that come within Sec. 162 are deductible for AGI, while legal fees related to employment or income production (Sec. 212), if deductible, are deductible from AGI (as itemized deductions), subject to the limitations of Sec. 67.

Editor's note: Annette Nellen is editor of The Tax Adviser's Campus to Clients column and a member of the AICPA's Individual Tax Technical Resource Panel. 1 Sec. 62(c) and Regs. Secs. 1.62-2(c)-(f).
Sec. 67 provides that miscellaneous itemized deductions are deductible only to the extent the total amount exceeds 2% of AGI. Sec. 67 lists various deductions that are not treated as miscellaneous itemized deductions. Legal fees are not included in the list; thus, if deductible from AGI, they are subject to the 2% limitation.

Another downside of legal fees classified as miscellaneous itemized deductions is that Sec. 56(b)(1)(A)(i) does not allow any deduction for miscellaneous itemized deductions for AMT purposes. An individual with significant legal fees that may be deducted from AGI can easily face an AMT liability. This has also led to litigation as taxpayers find alternative ways to obtain a more favorable tax treatment, particularly when taxable income was generated from the legal fees, which are included in calculating both regular tax and AMT—despite the fact that the related legal fees are not deductible for AMT purposes. Some of these cases are discussed later, along with the limited relief provided by the American Jobs Creation Act of 2004 (AJCA).

Sec. 263 requires expenditures related to improvements or an increase in value of property to be capitalized (rather than expensed). For example, legal fees paid to defend or perfect title to real property must be added to the basis of the property, rather than deducted.²

Court Decisions

The leading case on the classification of expenditures as business or personal (as well as deductible versus capitalizable)³ is the Supreme Court decision in Gilmore.⁴ This case examined the tax treatment of legal fees to defend a divorce action and protect the husband's business assets against claims by the wife. The husband argued that the fees were deductible because they were incurred to conserve property (stock) held for the production of income, a position the lower court had agreed with.

The Court reversed the lower court and held that the characterization of legal fees as business or personal depended on whether the claim's origin and character were the taxpayer's profit-seeking activities. The characterization did not depend on the consequences that might result from not defending or defeating a legal claim or action. The Court found that this approach tied to the language of Code provisions allowing deductions for business and profit-seeking activities. The Court also found that this was the equitable result likely intended by Congress. For example, if two individuals involved in car accidents while driving for personal pleasure were able to deduct related legal fees only if the lawsuit damages were to be paid from income-producing assets (rather than from income), the law would unfairly favor the driver with investment assets to protect.

The Gilmore decision created the "origin of the claim" test for characterizing legal fees as deductible, capitalizable, or nondeductible. The U.S. Claims Court has further elaborated on this test:

The object of the "origin of the claim" test is to find the transaction or activity from which the taxable event approximately resulted, Gilmore, 372 U.S. at 47, or the event that "led to the tax dispute." Keller, 688 F. 2nd at 681. The origin is defined by analyzing the facts and determining what the basis of the transaction is, and does not rely on purpose, consequence or result.⁵

Further elaboration from the Tax Court provides:

The inquiry is directed to the ascertainment of the "kind of transaction" out of which the litigation arose.... Consideration must be given to the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the claimed deductions were expended, the background of the litigation, and all facts pertaining to the controversy.⁶

EXECUTIVE SUMMARY

- If the origin of a claim that generated legal fees is personal, the fees are not deductible.
- Possible favorable treatment for legal fees includes either above-the-line deductions or adjustments to basis or selling price in a property transaction.
- Some taxpayers have claimed described legal fees in such a way that they directly reduce the related income.

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In Practice: Borderline Situations

In Woodward, the Court observed that a standard such as origin of the claim was likely to lead to borderline cases in which it is not easy to determine the nature of the origin. As noted earlier, the tax treatment of legal fees is a well-litigated area, and there are many court cases to consider in resolving borderline situations. This section provides guidance on identifying the origin of legal fees as capitalizable, business, employment, investment, or personal.

Capitalize Versus Expense

If legal fees have their origin in ownership or protection of property, they should be capitalized rather than expensed.

Example 1: B incurs legal fees to defend a challenge to the title of his rental property. The origin of the claim that leads B to incur legal fees is protection of his investment property. Thus, B must capitalize the fees per Sec. 263.7

Example 2: J is the majority shareholder of X Corp. J voted to extend the corporate charter, which the minority shareholders did not approve. State law requires J to purchase the shares of the minority shareholders. In a dispute as to the shares' value, legal fees were incurred. Application of the origin-of-the-claim test indicates that the legal fees were incurred to acquire the minority shares, rather than to maintain J's property. Thus, the legal fees must be capitalized, rather than expensed.8

Example 3: T's rental property was condemned by the state. T incurred legal fees to challenge the value set by the state and to receive interest on the delayed proceeds. T eventually received a higher payment for the property plus interest income. T must capitalize all of the attorney's fees. None of the fees can offset the interest income; the origin of the claim was the condemnation, and this is what T's attorney devoted his time to. There would have been no interest income if there had been no condemnation.9

Example 4: R and P incurred legal fees to challenge the amount their insurance company offered to pay them when their personal residence was destroyed by fire. They were successful in obtaining the higher damages they requested (for replacement value) and realized a gain on the destruction. R and P may not deduct the legal fees under Sec. 212 as being for the production of income. An argument that replacement value insurance was a financial arrangement separate from home ownership will fail because the home insurance policy and the home are connected (there would be no insurance without the house). The origin of the claim is the house. Costs associated with an asset's acquisition or disposition should be capitalized. Legal fees incurred to increase the insurance award are capital expenditures under Sec. 263 and result in a reduced gain on the disposition.10

Business or Investment Versus Personal

If the origin of a claim that generated legal fees is personal, the fees are not deductible (under Sec. 262). However, if the origin is connected with taxable income or stems from a trade or business activity, it is likely to be deductible. The following examples illustrate situations in which the origin of legal fees was personal or tied to maintenance of property held for the production of income or used in a trade or business.

Example 5: E incurred legal fees in attempting to recover damages from a rug-cleaning company to challenge the amount their insurance company offered to pay them when their personal residence was injured in an auto accident that occurred while he was driving to see a client. A incurred legal fees to recover damages for his physical injuries, which prevented him from continuing his work at the same level as prior to the accident. His legal fees are not deductible; their origin is the personal injuries, rather than a business activity.13

Example 9: T worked for a securities firm. During the course of his employment, he improperly sold insider information. When this was discovered, the SEC brought legal action against him. T incurred legal fees in defending himself. T may not deduct the legal fees because they were not incurred in a trade or business. Improper use of the information was not within the scope of his employment. Also, assuming his insider trading activities did not rise to the level of being a trade or business, they did not fall within Sec. 162.14 Finally, because the legal fees did not produce income and stemmed from the actions brought against T personally, they are not deductible under Sec. 212. Instead, the fees are disallowed under Sec. 262.

Example 10: H, a pilot, was arrested and charged with assault and battery while away...
from work. H incurred legal fees to defend himself. He will lose his pilot’s license and, therefore, his job as a commercial pilot if convicted of the charges. H may not treat the legal fees as connected with his employment because the origin is a personal matter that did not arise from his employment. The possible consequences of H losing his job are not relevant in categorizing the legal fees.15

Example 11: M served as executrix of a deceased friend’s estate. The friend’s son brought an action against M, alleging that she had fraudulently induced the father to remove the son as beneficiary of a life insurance policy and make a charitable trust the beneficiary. This lawsuit was settled with M receiving $20,000 from the trust (which she reported as income). M then brought a lawsuit against the son for malicious prosecution. She won, receiving both actual and punitive damages. M may not deduct her legal fees incurred in the two lawsuits because the origin is her personal relationship with the deceased and his son. Her status and fees as executrix and her administration of the estate were not challenged. All allegations stemmed from M’s relationship with the father that arose prior to his death. In the second lawsuit, M sought only personal vindication to repair damage caused by the first lawsuit.16

Business Versus Employment

Due to the different tax treatment of business expenses (deductible for AGI under Sec. 162) versus most employment-related expenses (deductions from AGI and limited to Sec. 67’s 2%-of-AGI rule), taxpayers have sometimes argued that legal fees are business expenses rather than employment-related expenses. Taxpayers have claimed that they are not employees because they were no longer employees during the time that the legal fees were incurred, even though the fees related to prior employment. Taxpayers have also argued that payments from an employer were part of a reimbursable plan, thereby allowing deduction of the legal fees for AGI under Sec. 62(a)(2)(A).

When it is not clear whether the taxpayer was an employee or independent contractor (self-employed), courts have applied the common-law rules to determine whether the payor had the right to control the taxpayer. Finally, when a taxpayer is both an employee and self-employed, disputes have arisen as to how to categorize legal fees incurred to protect both statuses. In all of the situations, the origin-of-the-claim test was applied, once the facts had been determined, to understand why legal fees were incurred. The following examples illustrate application of the test when the employment status of the taxpayer was not certain or more than one status was involved.

Example 12: X, a professional fiduciary of trusts, worked for T a few years after working for T. X also became a director and shareholder of T. A few years later, X and T had a dispute because X refused to follow the required advice of the investment committee. This was subsequently followed by notice to X that T would exercise the termination provision of the employment agreement. X filed a complaint against T alleging breach of contract and other causes. Three years later, the case was settled with T paying X $1.5 million. T incurred $100,000 of legal fees. Because the origin of the claim was X’s employment, the legal fees are an unreimbursed employee business expense treated as a miscellaneous itemized deduction. As such, they are limited to 2% of X’s AGI and may not be deducted for AMT purposes.17

Example 13: The facts are the same as in Example 12, except X believes the settlement payment to him by T and his past employee status make the payment received a reimbursement arrangement under Sec. 62(a)(2)(A). X’s argument fails because there is no reimbursement plan (as required under Secs. 62(a) and (c) and the related regulations), and the legal fees were not paid by X in connection with his services as an employee (they were paid for him to collect damages). Because there is no accountable plan for the legal fees, they are not a deduction for AGI, but as employment-related expenses they are a miscellaneous itemized deduction.18 The reimbursed expenses must be incurred during the course of employment and on behalf of the employer (among other requirements) to be considered paid under an accountable plan.19

Example 14: C, an attorney, works for the U.S. government. The government brought an action against her for allegedly performing private law practice activities during her work hours. C hired an attorney to represent her in the investigation. The origin of the claim here is C’s employment, not her private law practice. It does not matter that the consequences of the investigation include loss of her business reputation or that the government no longer allows her to practice law while employed in her current position. Instead, the origin must be the focal point, and the legal fees were incurred only because of the investigation at her place of employment. Under Sec. 62(a)(1), the legal fees are miscellaneous itemized deductions.20

15 Nadiask, 356 F2d 911 (2d Cir. 1966).
16 Siebling, 113 F3d 1243 (9th Cir. 1997).
17 Chaplin, TC Memo 2007-58. The court applied common-law rules to determine that the taxpayer was an employee rather than an independent contractor.
18 Alexander, 72 F3d 938 (1st Cir. 1995).
19 Biehl, 351 F3d 982, 986 (9th Cir. 2003).
20 Reynolds, 296 F3d 607 (7th Cir. 2002).
Nontaxable Awards

When legal fees are incurred and produce a damage award that is excluded from income (such as due to the application of Sec. 104), the fees are not deductible. Sec. 265 denies deductions for items allocable to tax-exempt income. Should the legal fees produce both tax-exempt and taxable income, the fees may be allocable between the two types of income.

Example 15: M brought a lawsuit against a merchant for physical injuries sustained while she was shopping in the merchant’s store. M received an award covering only her physical injuries. That award was excluded from her income under Sec. 104(a)(2). M may not deduct the legal fees incurred, because there was no production of taxable income (Sec. 212) and the litigation resulted in tax-exempt income (Sec. 265). If M had also collected taxable punitive damages, legal fees allocable to that award would be deductible.21

AMT and AJCA

The fact that miscellaneous itemized deductions are not allowed when computing AMT has left some individuals who received significant taxable awards or settlements with significant AMT liability. Many view this situation as contrary to the ability-to-pay concept that should exist in a tax system. Individuals and their tax advisers have tried various arguments to avoid the AMT hit. One that had mixed results in the courts was the position that a portion of the award represents the attorney’s contingent fee award and is not the litigant’s income.

Example 16: In 1998, B received a $500,000 settlement for physical injuries (nontaxable under Sec. 104) and punitive damages (taxable). B and his attorney had an agreement that the attorney would receive 40% of any award. B interprets this as meaning that 40% of the punitive damages are income to the attorney and not to him, so he does not report that portion on his tax return (and does not deduct that portion of the award as legal fees).

The advantage to litigants of reporting only their “share” of an award is that the amount treated as earned by the attorney eliminates the need for any miscellaneous itemized deduction for legal fees; thus, there is no AMT adjustment. Both regular taxes and AMT are reduced with this interpretation.

In Benci-Woodward,22 the taxpayers were not successful in arguing that they could exclude the attorneys’ fee from gross income. They claimed that the attorneys were entitled to a portion of the award under the contingent fee agreement. The court held that under state law, the attorney had no ownership right to the client’s judgment.

In contrast, in Banks,23 the taxpayer was successful (until the government won at the Supreme Court level). The government had argued that under the “anticipatory assignment of income” doctrine,24 the taxpayer could not assign his income to someone else. However, the appeals court relied on Cotnam,25 in which the court found that state law gave the attorney an equitable lien or interest in both the cause of action and any award. Thus, the taxpayer could not earn the portion of the award that represented the attorney’s contingent fee award. In Cotnam, the court found the anticipatory-assignment-of-income doctrine not applicable due to the legal nature of the arrangement. Thus, the appeals court agreed with the taxpayer that the portion of the award representing the attorney’s contingent fee was not includable in income. A similar result was found in Banaitis.26

The government appealed both the Banks and Banaitis cases to the Supreme Court (543 US 426 (2005)) and was victorious. The Court found that the anticipatory-assignment-of-income doctrine was applicable and that the taxpayer/litigant retained dominion over the cause of action (the income-generating asset) throughout the litigation. The Court rejected any interpretation of the attorney-client relationship as being a principal-agent one. The Court held that a litigant’s gross income includes all parts of the award or settlement that are taxable without reduction for any contingent fee paid to the attorney.

Before the Court ruled on this matter, Congress stepped in and provided relief to future litigants. Section 703(b) of the American Jobs Creation Act of 2004 (P.L. 108-357) added Secs. 62(a)(20) and (e). The new provision allows an above-the-line deduction for costs of specified lawsuits. The deduction may not exceed the amount included in the litigant’s income for the year on account of the judgment or settlement resulting from the suit or claim (any excess should be a miscellaneous itemized deduction). With this change, Congress basically eliminated the Sec. 67 deduction limitation and AMT concerns of litigants who otherwise would have to treat legal fees related to taxable awards as miscellaneous itemized deductions limited for regular tax and nondeductible for AMT.

The types of actions covered are those involving:
1. A claim of unlawful discrimination (as defined at Sec. 62(e)).
2. A claim of a violation of Title 31 of the U.S. Code, Chapter 37, Subchapter III (certain claims against the U.S. government).
3. A claim made under Section 1862(b)(3)(A) of the Social Security Act (certain private causes of action under Section 1395y(b)(3)(A) of the Public Health and Welfare Code).

21 Metzger, 88 TC 834 (1987), aff’d without pub. op. 845 F2d 1013 (3d Cir. 1988); Bent, 835 F2d 67 (3d Cir. 1987).
23 Banks, 345 F3d 373 (6th Cir. 2003).
25 Cotnam, 263 F2d 119 (5th Cir. 1959).
26 Banaitis, 340 F3d 1074 (9th Cir. 2003). The Ninth Circuit reached different results in Benci-Woodward and Banaitis due to differences between California and Oregon laws.
Sec. 62(e) lists 18 types of "unlawful discrimination" actions. These include certain violations under the Civil Rights Act of 1991, the National Labor Relations Act, the Fair Labor Standards Act of 1938, the Family and Medical Leave Act of 1993, and several others. Sec. 62(a)(20) is effective for legal fees paid after October 22, 2004, for judgments or settlements that occur after that date.

This new provision should provide Sec. 67 and AMT relief to many successful litigants receiving taxable awards and settlements. However, the provision is not all-inclusive, and there are still types of awards for which legal fees will continue to be treated as below-the-line deductions subject to the 2% of AGI limitation for miscellaneous deductions and disallowed for AMT.

**Special Whistleblower Award Rule**

The Tax Relief and Health Care Act of 2006 (P.L. 109-432) made changes to the IRS reward program for individuals who provide information on certain tax violations. The changes also included the addition of Sec. 62(a)(21), to allow an above-the-line deduction for legal fees paid by an individual in connection with a whistleblower award under Sec. 7623(b). The deduction for AGI may not exceed the amount included in the individual's income for the tax year on account of the award. This provision is limited in application, and would not apply to other fees related to whistleblower awards outside of Sec. 7623(b) unless covered by Sec. 62(a)(20).

**Allocation of Legal Fees**

When legal fees originate from different claims, an allocation is needed to determine the tax treatment. For example, if an individual incurs legal fees to obtain fair value in a condemnation of property, the legal fees originate from the condemnation and are part of the property transaction (capitalizable). If the award also includes prejudgment interest, the related legal fees are deductible. The legal fees need to be allocated between the two awards so the proper tax rules can be applied.

**Example 17:** B and C's personal residence was damaged by flood and then destroyed by the city. B and C brought an action for inverse condemnation against the city. The agreement with their attorney provided for a 25% contingent fee plus $125 per billable hour worked. They were awarded $140,000 for the condemnation and $160,000 of pre-judgment interest. Applying the origin-of-the-claim test, the legal fees attributable to the $140,000 are nondeductible under Sec. 263, while those attributable to the interest are deductible from AGI under Secs. 212 and 62. The attorney spent 3% of his total billable hours in obtaining the interest award.

**Note:** In this instance, it would not be appropriate to allocate the attorney's fees based on the total award (i.e., treating 160/300 as deductible) because it does not reflect the work performed to obtain the interest.

**Tax Policy Considerations**

The origin-of-the-claim test satisfies some key principles of good tax policy. As noted by the Court in *Gilmore*, "If the relative impact of a claim on the income-producing resources of a taxpayer were to determine deductibility, substantial 'uncertainty and inequity would inhere in the rule.'" Categorizing legal fees using the origin of a claim rather than the assets one has to protect is more likely to treat taxpayers similarly and provides more objectivity to the law.

Some taxpayers have described the treatment of legal fees categorized as miscellaneous itemized deductions as unfair and inequitable. The courts have been unsympathetic to such arguments and note that any remedy is under the purview of Congress, not the courts. The courts have also noted that the law is equitable in these situations because it treats all similarly situated taxpayers similarly. In *Alexander*, the court noted that, despite the AMT, the taxpayers were not denied their below-the-line deduction for the legal fees. It also noted that the AMT serves to ensure that taxpayers with substantial economic income will pay some amount of tax, despite using their combination of deductions, exclusions, and credits. The court also noted that equitable arguments cannot override the plain meaning of the law.

Income tax preferences, such as deductions, are often justified because they are important in determining a person's ability to pay; other preferences are justified as important to supporting economic or social policies. But the principle of simplification is also relevant. For example, while it may be justifiable to allow employees to deduct costs of generating their employment income, it would pose time-consuming recordkeeping burdens and raise issues as to whether something was purely related to work or also had some personal benefits. In addition, many employers reimburse employees for significant costs required for work (such as travel), thereby leaving

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27 Regs. Sec. 1.212-1(k).
28 Leonard, 94 F3d 523 (9th Cir. 1996). But see Baylin, 43 F3d 1451 (Fed. Cir. 1995), and Chun, 80 TC 1104 (1983).
30 *Alexander*, 72 F3d 938 (1st Cir. 1995).
the employees with minimal unreimbursed costs. But these arguments do not carry over well to justify similar treatment for income from awards and settlements.

Awards and settlements are unusual events and often require significant costs by individuals to generate the award. In some cases, without the costs, the award income would not exist. Basically, such income and expenses are not similar to other more common types of income generated by individuals such as wages and investment income. To treat expenses of award income like the more common types of income can arguably be viewed as unfair.

**Conclusion**

The origin-of-the-claim test is the approach individuals must use to determine the nature of their legal fees and thereby decide how they are treated for tax purposes. It is important to examine the facts of the claim and ask why the individual hired an attorney. Answering these questions should then enable practitioners to determine if the fees are nondeductible personal expenses, business or income related, or capitalizable as related to a property interest. The potential consequences of not obtaining legal assistance are not relevant to classify the fees. There are many rulings to provide assistance in applying the origin-of-the-claim test.

Perceived inequities in the treatment of large awards and legal fees due to the 2% of AGI limitation of Sec. 67 and the AMT rules have been partially but not completely addressed by recent law changes. Government revenue concerns make it unlikely that these perceived inequities will be completely removed from the law. Practitioners should help clients analyze settlement options and legal fee arrangements by explaining the regular and AMT consequences of the fee arrangements before fee structures and settlements are finalized.