Final(?) Thoughts
On the Biehl Decision
By Stephen B. Cohen and Laura Sager

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Introduction
In a series of articles in Tax Notes, we have criticized and Professor Brant J. Hellwig has defended last year’s Tax Court decision in Biehl v. Commissioner.¹ The taxpayer in Biehl had settled an unlawful-termination-of-employment claim for a total of $1.2 million, with the employer paying $799,000 directly to the taxpayer and $401,000 directly to the taxpayer’s attorney to cover the fee for legal services.² The Tax Court held that the employer’s payment of the attorney’s fee did not qualify as a reimbursed employee business expense under section 62(a)(2)(A) because, among other things, the taxpayer was not a current employee when the expense was incurred.³ Consequently, the taxpayer’s income under the alternative minimum tax was the full settlement amount of $1.2 million without any deduction for the $401,000 attorney’s fee that was the cost of obtaining the settlement.⁴

In our critique of the Biehl opinion, we noted that the taxpayer had satisfied all the express requirements of section 62(a)(2)(A) and the regulations thereunder,⁵ which do not include the Tax Court’s additional requirement that the taxpayer be a current employee.⁶ We called attention to a First Circuit decision that interpreted language in section 62(a)(1), virtually identical to language in 62(a)(2)(A), as applying to former as

¹Employee business expenses that do not satisfy section 62(a)(2)(A) are not deductible in computing adjusted gross income. Section 62(a). Expenses that are not deductible in computing adjusted gross income are “itemized deductions.” Section 63(d). Itemized deductions are also “miscellaneous itemized deductions” unless specifically exempted, and employee business expenses, such as the expense in Biehl, are not among the exempted items. Section 67(b). Under the alternative minimum tax, miscellaneous itemized deductions are not deductible at all. Section 50(e)(1)(A)(i).


³At one point, Prof. Hellwig suggests that perhaps section 132(a)(3), rather than section 62(a)(2)(A), should determine the tax treatment of the attorney’s fee in Biehl. He notes that the settlement agreement provided for the employer to pay $401,000 directly to the taxpayer’s attorney to cover the fee for legal services. He then cites temp. reg. section 1.62-11(e)(5), which states:

   In the case of an employer . . . who pays an employee’s expenses directly instead of reimbursing the employee, the employee should be treated as if he

   were a current employee for the purposes of income and payroll tax withholding, see infra note 9. In addition, treating the taxpayer as a current employee satisfies the obligation to construe the code so that it does not negate federal civil rights protections.

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²118 T.C. at 469.

³Id. at 482. For purposes of our argument, we assume, as did the Biehl court, that the attorney’s fee portion of the settlement is includible in the plaintiff’s gross income under the prevailing rule in the Ninth Circuit where the taxpayer resided. See Benci-Woodward v. Commissioner, 219 F.3d 941, Doc 2000-20007 (7 original pages), 2000 TNT 144-8 (9th Cir. 2000).
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well as current employees, an interpretation that appears to have been followed by the Tax Court until its decision in *Biehl*. We also argued that even if section 62(a)(2)(A) is construed to include a current-employee requirement, the taxpayer in *Biehl* should have been regarded as a current employee, just as a former employee who recovers lost wages is so regarded by the IRS and the courts for purposes of income and payroll tax withholding. Most important, we demonstrated that the Tax Court’s construction of section 62(a)(2)(A) negates federal civil rights statutes that prohibit discrimination in employment on the grounds of disability, national origin, race, or sex and that, under prior Supreme Court decisions, the Tax Court was obligated to attempt to avoid an interpretation of section 62(a)(2)(A) that defeats federal civil rights protections.

(footnote 9 continued in next column.)

7Alexander v. Commissioner, 72 F.3d 938, 944-45, Doc 96-602 (21 pages), 96 TNT 1-74 (1st Cir. 1995). Section 62(a)(2)(A) applies to expenses “in connection with the performance by the taxpayer of services as an employer” provided that the reimbursement arrangement with substantiation and non-valuation-excess reimbursement-amount requirements are also met. Using virtual identical language, section 62(a)(1) applies to expenses that are not “attributable to . . . the performance of services by the taxpayer as an employee.” In Alexander, the First Circuit held that the expense for an attorney’s fee incurred by a former employee in a wrongful-termination-of-employment suit was “attributable . . . to the performance of services by the taxpayer as an employee” under the language of section 62(a)(1), even though the former employee was not currently employed and was not currently performing services. 72 F.3d at 944-45 (1st Cir. 1995).


9In both *Bennet* and *Alexander*, the taxpayer who had settled an unlawful-termination-of-employment claim argued that the expense for the attorney’s fee satisfied section 62(a)(2)(A). In *Bennet*, the Tax Court stated that the expense did not satisfy section 62(a)(2)(A) because the taxpayer failed to provide adequate substantiation of the expense as required by section 62(c)(1). T.C. Memo. 2001-127. In *Alexander*, the Tax Court stated that the settlement agreement failed to qualify as a “reimbursement or other expense allowance arrangement” under section 62(a)(2)(A) because the employer “was not responsible for reimbursing petitioner for his legal fees or for arranging to pay the fees directly.” T.C. Memo. 1995-51 (emphasis added). Neither case mentioned a current-employee requirement as a basis for holding that the expense did not satisfy section 62(a)(2)(A), even though, in each of these cases, as in this case, the taxpayer was a former rather than a current employee when the expense was incurred. The *Biehl* case is easily distinguished from both *Bennet* and *Alexander*. Unlike *Bennet*, the taxpayer in *Biehl* substantiated that the expense was actually incurred. 118 T.C. at 469. Unlike *Alexander*, the employer in *Biehl* was responsible for reimbursing the taxpayer by arranging to pay the fee directly to the taxpayer’s attorney. Id.

10Cohen and Sager, “Prolong,” supra note 1 at 383. Neither Prof. Hellwig nor the Tax Court acknowledged that, for purposes of income and Social Security tax withholding, a former employee for the person employing him, “by an employee for the person employing him,” and “for his employer” — imply a current employer-employee relationship. Nevertheless, a former employer must withhold income and Social Security taxes on amounts paid to a former employee even if the amounts compensate the employee for wages that would have been earned after the termination of employment, that is, at a time when the taxpayer was no longer a current employee. Gerbec, 164 F.3d at 1026.

11Cohen and Sager, “Kafka,” supra note 1 at 1509-10; “Prolong,” supra note 1 at 381. We explained in our previous articles that in civil rights cases, the plaintiff’s damages are often too modest to enable the plaintiff to obtain representation under a contingency fee agreement. City of Riverside v. Rivera, 477 U.S. 561, 577 (1986) (plurality opinion). Therefore, Congress has provided for the prevailing plaintiff in civil rights litigation to recover not only damages, but also a reasonable amount to pay for the services of the plaintiff’s attorney. 42 U.S.C. section 1988(b) (Civil Rights Attorney’s Fees Awards Act of 1976); 42 U.S.C. section 2000a-3(b) (Civil Rights Act of 1964); 42 U.S.C. section 2000e-5(k) (Civil Rights Act of 1964); 42 U.S.C. section 12205 (Americans With Disabilities Act of 1990). The potential attorney’s fee award enables the civil rights plaintiff whose damages are not sufficient for a contingency fee agreement to obtain representation. Quaratino v. Tiffany & Co., 166 F.3d 422, 426 (2d Cir. 1999); Rivera, 477 U.S. at 576-79. When the damages for employment discrimination are modest compared with the attorney’s fee, the denial of an AMT deduction for the fee will result in the civil rights plaintiff retaining little or none of the damages after paying taxes on the gross amount, which includes the attorney’s fee as well as the damages. In many cases, the “successful” plaintiff will even suffer a net loss, because the tax liability will exceed the damages received. In those cases, the effective rate of tax on the plaintiff’s net recovery exceeds 100 percent. If “success” in litigation means not only retaining little, if any, compensatory damages after taxes but also incurring a significant risk of a net loss, victims of employment discrimination will be reluctant to sue. Thus, the *Biehl* decision has the practical effect of negating the civil rights protections afforded by such statutes.

(emphasis added). The words of the statute — “individuals in his employ,” “by an employee for the person employing him,” and “for his employer” — imply a current employer-employee relationship. Nevertheless, a former employer must withhold income and Social Security taxes on amounts paid to a former employee even if the amounts compensate the employee for wages that would have been earned after the termination of employment, that is, at a time when the taxpayer was no longer a current employee. Gerbec, 164 F.3d at 1026.
Prof. Hellwig’s recent contribution to the debate, “Additional Thoughts on the Biehl Decision,” like his earlier article and the Tax Court’s opinion in Biehl, does not acknowledge the obligation to interpret the Internal Revenue Code in a way that preserves the purposes of both the tax code and federal civil rights law. Instead, he introduces an entirely new point: That a different provision of the Internal Revenue Code, section 132(a)(3), justifies the current-employee requirement that the Tax Court read into section 62(a)(2)(A).14

Below we explain why Prof. Hellwig’s novel argument regarding section 132(a)(3) is highly strained, ignores relevant factors, and is particularly unacceptable in light of the obligation to construe the Internal Revenue Code so as not to defeat the purposes of federal civil rights law. Moreover, Prof. Hellwig’s argument reminds us of the “bait and switch” that retailers may use to entice unwitting customers. In the classic bait and switch, a customer is induced to enter a store by the prospect of buying a specified item at a cheap price — that’s the bait. Once inside the store, the customer learns that the specified item at the cheap price is no longer available but that a costly substitute is in plentiful supply — that’s the switch.

The Bait: Section 132(a)(3)

Prof. Hellwig’s bait is section 132(a)(3), which permits an employee to exclude employer-provided goods and services from gross income provided that the cost would be deductible as a section 162(a) business expense if paid for by the employee.15 Prof. Hellwig cites a regulation stating that the term “employee,” for purposes of section 132(a)(3) “means [a]ny individual who is currently employed by the employer.”16 He then argues that “[t]here is no reason why tax treatment should turn on” whether the employer provides goods and services to the employee directly (so that section 132, an exclusion provision, applies) or whether the employer reimburses the employee for the expense of goods and services (so that section 62(a)(2)(A), a deduction provision, applies).17 In other words, he contends that, for the sake of consistency, both section 132(a)(3) and section 62(a)(2)(A) should be interpreted to impose a current-employee requirement.

In stating his case for construing the language of section 62(a)(2)(A) to include a current-employee requirement, Prof. Hellwig does not mention the First Circuit decision interpreting virtually identical statutory language in section 62(a)(1) as including former as well as current employees.18 Nor does he consider the fact that even if a current-employee requirement is read into sections 132(a)(3) and 62(a)(2)(A), such a requirement would not necessarily justify the result in Biehl. The taxpayer in that case could have been treated as a current employee for the purpose of these provisions, just as a former employee who recovers lost wages is treated as a current employee by the IRS and the courts for purposes of income and payroll tax withholding.19

Moreover, consistency between sections 132(a)(3) and 62(a)(2)(A), which Prof. Hellwig desires, does not require reading a current-employee requirement into section 62(a)(2)(A). Consistency can also be achieved if neither statute is construed as incorporating a current-employee requirement. Such consistency of course requires interpreting the Treasury regulation as providing an example of the usual meaning of the term “employee” under section 132(a)(3) rather than an exclusive definition or rigid requirement. In fact, the IRS has adopted such a reading of the regulation, which takes us to Prof. Hellwig’s first switch.

Switch No. 1: Employer Benefit

Halfway through the argument that section 132(a)(3) applies only to current employees, Prof. Hellwig discloses that in interpreting section 132(a)(3), the IRS has on occasion waived the current-employee requirement of the regulation.20 Rev. Rul. 92-69 provides that employment counseling services furnished to a terminated employee by a former employer can qualify for exclusion under section 132(a)(3) even though a terminated employee is obviously a former employee at the time when the expense for the employment counseling services is incurred.21

So much, one might think, for the rigid current-employee requirement of section 132(a)(3) and the argument that, for the sake of consistency, section 62(a)(2)(A) should also be interpreted as imposing a current-employee test. If anything, given the revenue ruling, perhaps the desire for consistency between sections 132(a)(3) and 62(a)(2)(A) should mean that the Tax Court decision in Biehl was mistaken, because the rigid current-employee requirement that the Tax Court created for purposes of section 62(a)(2)(A) is inconsistent with the revenue ruling’s rejection of such a requirement for purposes of section 132(a)(3).

Prof. Hellwig, however, makes no such concession. Instead, he makes a switch. Having enticed the reader to believe that the Tax Court decision in Biehl was correct because of a current-employee requirement under section 132(a)(3), he advances first one different argument and then another in attempting to justify the Biehl decision. Moreover, he does so in the guise of distinguishing the facts of Rev. Rul. 92-69 from the facts of Biehl.

Prof. Hellwig first argues that the expense in the revenue ruling provided a substantial benefit to the employer through “the promotion of a positive corporate image, the maintenance of employee morale, and

12Hellwig, “Additional Thoughts,” supra note 1.
13Hellwig, “Activism,” supra note 1.
14Hellwig, “Additional Thoughts,” supra note 1 at 1417-18.
15Section 132(d).
16Reg. section 1.132-1(b)(2)(i), quoted in Hellwig, “Additional Thoughts,” supra note 1 at 1418.
17Hellwig, “Additional Thoughts,” supra note 1 at 1419.
18Alexander v. Commissioner, 72 F.3d 938, 944-45 (1st Cir. 1995).
19See supra note 9.
20Hellwig, “Additional Thoughts,” supra note 1 at 1418.
211992-2 C.B. 51.
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the avoidance of wrongful termination suits" while the expense in Biehl that enabled the employer to avoid further litigation did not provide a substantial benefit.22 Thus, according to Prof. Hellwig, the avoidance of a wrongful termination suit may provide a substantial benefit to the employer, but the avoidance of further litigation once such a suit has started cannot.

Prof. Hellwig’s distinction between avoiding litigation and avoiding further litigation seems questionable, to say the least. Moreover, in making the distinction, he has switched the ground for arguing that Biehl was correct. The ground is no longer a current-employee requirement but an employer-benefit requirement, which the expense in Biehl purportedly fails to satisfy. The problem with this different requirement is that neither section 132(a)(3) nor section 62(a)(2)(A) for that matter, makes any mention whatsoever of an employer-benefit requirement. Section 132(a)(3) requires only that the expense, if paid for by the employer, would be deductible under section 162(a), and it is well established that the expenses of a wrongful-termination-of-employment suit meet this test.23 Section 62(a)(2)(A) requires that an employee provide substantiation and not be permitted to retain any excess reimbursement amount, but again there is no mention in the statute or the regulations of any additional employer-benefit requirement.24

Switch No. 2: Reg. Section 1.62-2(d)(3)(i)

Prof. Hellwig next argues that the facts of Biehl differ from the facts of the revenue ruling because the employer in Biehl would have been willing to pay $1.2 million to settle the case regardless of the amount of the taxpayer’s expense for the attorney’s fee.25 In citing this difference, Prof. Hellwig refers to reg. section 1.62-2(d)(3)(i), which states:

If a payor arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) business expenses . . . , the arrangement does not satisfy [section 62(a)(2)(A)].

Once again Prof. Hellwig’s ground has moved (and this is not Hemingway’s The Sun Also Rises). Now the reason why the expense in Biehl does not satisfy section 62(a)(2)(A) has nothing to do with either section 132(a)(3), a current-employee requirement, or an employer-benefit requirement but instead involves a regulation issued under section 62(a)(2)(A).

As we explained in an earlier article, however, that regulation is inapposite.26 The facts of Biehl do not violate the regulation. At the time of the settlement agreement, the expense for the attorney’s fee had already been incurred. Therefore, the settlement agreement did not arrange for the payment of $1.2 million regardless of whether the taxpayer incurred the expense of the attorney’s fee.

The facts of Biehl do bear a superficial resemblance to the kind of arrangement referred to in the regulation — in which the employer arranges to pay a total amount regardless of whether the taxpayer incurs business expenses — since the employer in Biehl would presumably have been willing to pay a total of $1.2 million to settle the litigation regardless of how much the taxpayer had incurred for the expense of the attorney’s fee.

Nevertheless, despite this resemblance, the two situations are very different in light of the purpose of the statute. The purpose of section 62(a)(2)(A) is to limit the deduction of items that are claimed as business expenses under section 162(a) but provide significant

Footnote 26 continued in next column.)

22Hellwig, “Additional Thoughts,” supra note 1 at 1419 (emphasis added).
23In Biehl, the Tax Court acknowledged that the expense qualified under section 162(a) as paid or incurred in carrying on the business of an employee, Biehl, 118 T.C. at 477-78, since “[i]t is well settled that the costs of a former employee’s prosecution of a wrongful termination claim are deductible by him as a trade or business expense under section 162(a).” 118 T.C. at 477.
24Section 62(c)(1).
25Section 62(c)(2).
26The Tax Court in Biehl did construe section 62(a)(2)(A) to apply only if the employer benefits when the expense is incurred. To justify this employer-benefit requirement, the Tax Court relied primarily on statements concerning employer benefit that appeared in a 1988 House Conference Report accompanying the enactment of sections 62(c)(1) and 62(c)(2). H. Conf. Rep. No. 100-998, at 202-03 (1988). The report referred to the “expense of the employer’s business,” to the employee “acting as an agent of the employer,” and to a “true reimbursement” as “incurred on the employer’s behalf and for the employer’s benefit.” Id. However, these references should be understood in light of the specific abuse of so-called "nonaccountable plans," under which "(1) the employee is not required to substantiate the expenses covered by the arrangement to the person providing reimbursement, or (2) the employee has the right to retain amounts in excess of the substantiated expenses covered under the arrangement." Id. at 201-02. All references to employer benefit in the Conference Committee Report concerned nonaccountable plans, which the report discussed at some length. When the Conference Committee Report referred to a "true reimbursement," id. at 203, in which the expenses are "for the employer’s benefit," id., it clearly meant to contrast those situations in which the taxpayer must substantiate the expenses and is not permitted to retain excess amounts with the absence of those requirements in nonaccountable plans. These references were not intended to impose an employer-benefit requirement. Moreover, the concerns about nonaccountable plans expressed in the 1988 Conference Committee Report — and therefore the references to employer benefit — are irrelevant in Biehl. Every penny of the reimbursement amount in Biehl was accounted for. The taxpayer presented evidence substantiating the $1.2 million settlement amount and the obligation to pay one-third of the amount under the contingency fee agreement. 118 T.C. at 469. In addition, it would have been impossible for the taxpayer to retain any excess reimbursement amount because the one-third of the settlement amount allocated to the attorney’s fee was paid directly to the attorney. Id.
27Hellwig, “Additional Thoughts,” supra note 1 at 1419.
28Cohen and Sager, “Prolong,” supra note 1 at 383-84.
personal consumption benefits. In the situation to which the regulation refers, the employee can choose to spend up to the entire amount either for business purposes or for personal consumption. The fact that the employee has the choice raises a serious question: whether expenses claimed by an employee as business expenses are truly business expenses, or rather “have characteristics of voluntary personal expenditures.”

Because of this doubt about the actual character of the expenses, reg. section 1.62-2(d)(3)(i) prohibits section 62(a)(2)(A) from applying if the employer “arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) business expenses.”

In Biel, however, the fact that the employer would have been willing to pay the same amount regardless of how much the taxpayer incurred for the expense of the attorney’s fee does not raise a similar doubt. The expense of the attorney’s fee clearly did not provide any personal consumption benefits, and the amount of the expense was fixed in advance by the fee agreement between the taxpayer and the attorney. The regulation should not be construed to apply to the portion of a settlement agreement allocated to the expense of an attorney’s fee, not only because there is no literal violation in this case, but also because the arrangement does not facilitate the kind of abuse at which the regulation is aimed. In addition, and most important, application of the regulation to this expense would violate the obligation, under prior Supreme Court decisions, to construe the tax code and federal civil rights statutes in a manner that preserves the purposes of both.

 IRS Drops Claim That It’s Keeping A Foreign Student Census

By John A. Bogdanski

Last year, I wondered aloud in Tax Notes (“Is the IRS the Federal Watchdog Over Foreign Students?” Apr. 8, 2002, p. 261) whether the IRS was keeping an illegal census of foreign students. My question was prompted by passages in an IRS publication that indicated that it was.

I am happy to report that in this year’s version of that publication, Publication 678-FS (Rev. 2002), those passages have been deleted. Thus, one of three alternative sets of facts is likely to be true: (1) the IRS was never in fact keeping such a census; (2) it was, but it has stopped doing so, or (3) it still is, but it has stopped owning up to it. (I’m inclined to think alternative (1) is the true answer — that the authors of the publication were simply mistaken — but I’m just guessing.)

To recap the issue, the 2001 edition of Publication 678-FS, a training guide for those who help foreign students and scholars prepare their U.S. tax forms, asserted that “[e]ven a [nonresident] student or scholar who had no income must still file Form 8843,” and “Form 8843 must be filed for every family member who is in the U.S. on an F-2 or J-2 visa.” Thus, every foreign student and scholar in the country was purportedly required to file an annual form with the IRS, even if he or she had no income, domestic or foreign. And the requirement supposedly extended to accompanying family members as well.

The training manual went on to declare: “This form allows the U.S. to do a census of international visitors, and ‘There is no monetary penalty for failure to file, but failure can jeopardize later residency status.” It was this language that led me to conclude that the IRS might be taking an illegal census of foreign students, unrelated to the collection of taxes but with an agenda related to immigration or national security.

The 2002 version of the manual has eliminated the statement about the “census.” And the sentence regarding the consequences of not filing the form has been changed. It now reads: “There is no monetary penalty for failure to file, but days of presence can’t be excluded from the substantial presence test unless Form 8843 is filed.”

The change is a welcome relief to staff members at the nation’s colleges and universities, who try to provide tax help to hundreds of thousands of foreign students and scholars studying at any given time on U.S. soil. The new verbiage in the publication reaffirms the role of Form 8843, which demands details about a foreigner’s comings and goings, as a tax form, not an immigration tracking form or some other sort of anti-terrorism tool. (Meanwhile, school officials have been

29The Joint Committee on Taxation explained that Congress decided to limit the deduction of employee business expenses that do not satisfy section 62(a)(2)(A), along with other miscellaneous itemized deductions, because “these expenses have characteristics of voluntary personal expenditures.” Staff of the Joint Comm. on Tax’n, 99th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, 78 (Comm. Print 1987) (emphasis added). The 1988 Conference Committee Report, accompanying the enactment of sections 62(c)(1) and 62(c)(2), which provide additional requirements for satisfying section 62(a)(2)(A), noted that “some unreimbursed expenses that an employee chooses to incur are sufficiently personal in nature that they would be incurred apart from the taxpayer’s performance of services as an employee.…” H.R. Conf. Rep. No. 100-998, at 202 (emphasis added). This purpose is also evident in the language of section 62(c)(2), which prohibits the employee from retaining reimbursement amounts in excess of substantiated expenses. The objective is to prevent taxpayers from obtaining a section 62(a)(2)(A) deduction for cash reimbursements that can be used for personal consumption rather than substantiated business expenses.


31See supra notes 10-11.
coming up to speed on SEVIS — the Student and Exchange Visitor Information System — a new internet-based tracking system by which they report on their students to the newly rechristened Bureau of Citizenship and Immigration Services.)

Retained in the IRS publication, however, are the puzzling assertions that “[e]ven a student or scholar who had no income must still file Form 8843,” and that “Form 8843 must be filed for every family member who is in the U.S. on an F-2 or J-2 visa.” As I explained in the previous Tax Notes piece, a student, scholar, or family member with no income of any kind, U.S. or foreign, should not have to file the form, because the form merely supports a claim of tax nonresidency. For a person with no income from any source, status as a resident or nonresident is irrelevant, because no tax return need be filed in either event.

Thus, the authors of the IRS training manual still have a way to go before they get the rules in this area 100 percent correct. But at least the most curious of their assertions have now been retracted.