I. THE LOSS OF MISCELLANEOUS ITEMIZED DEDUCTIONS

The 2017 Tax Cuts and Jobs Act was signed into law on December 22, 2017. With the new law, all job expenses and miscellaneous itemized deductions which are reported by individuals on Schedule A of Form 1040—the individual federal income tax return—are suspended effective for tax years beginning January 1, 2018 and ending December 31, 2025. The suspension of these deductions was implemented by adding Code section 67(g) (2017 Tax Cuts and Jobs Act Section 11045(a)). Section (g) provides:

Notwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026.

The statutory basis for miscellaneous itemized deductions is set out in Section 67(a) of the Internal Revenue Code (“IRC”) which provides as a general rule: “In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds two percent of adjusted gross income.” IRC Section 67(b) carve out a list of deductions that are not subject to the two percent floor leaving all others not listed subject to the two percent of AGI limitation. The deductions subject to the two percent limit are entered on Schedule A of Form 1040, lines 21-23.
Unreimbursed Business Expenses

Generally, the deduction for employee business expenses includes, for example, unreimbursed employee expenses for job travel, union dues, and job education. The deduction for unreimbursed employee business expenses is entered on line 21 of Schedule A.

The instructions to Schedule A as well as IRS Publication 529 and IRS Temporary Regulation Section 1.67-1T shed light on the types of expenses that can be deducted provided they are unreimbursed, incurred in the current tax year for carrying on the taxpayer’s trade or business of being an employee, and ordinary and necessary. They include:

1. Business travel, transportation, lodging away from home, meals and entertainment;
2. Safety equipment, small tools, and supplies needed for employment;
3. Uniforms required and not suitable to everyday use;
4. Protective gear such as hard hats, safety shoes and glasses;
5. Dues to professional organizations;
6. Physical exams required by an employer;
7. Professional subscriptions;
8. Job-seeking fees;
9. Home office expenses;
10. Work related educational expenses;
11. Legal fees related to doing or keeping a job; and
12. Continuing education.

Expenses for items like subscriptions, clothing, and professional fees that are personal in nature have never been deductible. It was necessary for those expenses to be related to employment. Now even if related to employment they lose their deductibility.

Tax Preparation Fees

Tax Preparation expenses include professional fees, electronic filing expenses, tax preparation software, and publications. Tax preparation fees were claimed on line 22 of Schedule A.

Miscellaneous Expenses

Other miscellaneous expenses were claimed on line 23 of Schedule A. Included among miscellaneous expenses are those described under IRC Section 212 as they were not excluded from coverage under IRC section 67(b). Section 212 allows individuals to deduct “all the ordinary and necessary expenses paid or incurred during the taxable year: 1) for the production or collection of income; 2) for the management, conservation, or maintenance of property held for the production of income; or 3) in connection with the determination, collection, or refund of any tax.” IRS Publication 529 specifically directs the taxpayer to include as Line 23 miscellaneous expenses “any ordinary and necessary expenses to produce or collect reportable income, to manage, conserve, or maintain property held for producing such income, or to determine, contest, pay or claim a refund of any tax.”

Speaking in the past tense, in practice this meant that individuals could deduct legal fees that were paid for having their taxes prepared and for advice associated with tax planning. It also meant that individuals could deduct the legal fees related to collecting taxable alimony or for tax advice related to a divorce settlement provided the legal invoice was specific as to how much was related to tax advice. It also meant that they could take a deduction up to two percent of AGI for legal fees incurred in litigation matters that generated income. This was particularly important in contingent fee matters.

The impact of losing these deductions highlights the disparity of tax treatment for business expenses compared with individual and individual employee expenses.

Individual Expenses Compared with Business Expenses

Many of the expenses that could have been deducted by individuals under IRC Section 67 and are no longer deductible on Schedule A, may be deducted by businesses under Section IRC 62(a) and reported on Schedule C to Form 1040. So for example, businesses still have the ability to deduct legal fees and tax preparation fees in their entirety as business expenses while under the new law individuals are no longer entitled to deduct these expenses at all.

In the not-too-distant past there was litigation over whether an expense was related to employment or
whether it was related to the taxpayer being in business for himself. This was often an issue for sole proprietors. At stake at the time was whether an expense could be deducted in full (above the line) as a business expense thereby reducing adjusted gross income rather than an expense subject to the two percent of adjusted gross income limit. So there is authority that tells us that a sole proprietor’s tax preparation expenses that are business related can be deducted under IRC Section 62 above the line on Schedule C where they were used to determine adjusted gross income. Rev Rul 92-29, 1992-1 CB 20 and IRS Letter Ruling 9234009.

The disparity may compel some to consider shifting status from “employee” to self-employed or independent contractor. IRS has historically scrutinized claims of independent contractor status and penalized employers for mischaracterizing their workers. There are IRS Rulings, Employment Tax Regulations, and case law that assist in determining whether someone should be treated as an employee or as self-employed. A single compelling factor is whether or not the individual has tax withheld from their compensation. But there are other compelling factors that require consideration in the absence of a Form W-2. Because the incentive to be in business rather than to be paid by W-2 is strong, IRS will likely be actively focused on whether an individual is properly classified as an employee or independent contractor with all of the scrutiny it has given this issue in the past.

As the Supreme Court of the United States remarked in 1947 in the case of U.S. v. Silk, 331 U.S. 704 (1947) whether someone is an employee or independent contractor is based upon “the total situation, including the risk undertaken, the control exercised, and the opportunity for profit from sound management.” The drivers in the Silk case, owned their own trucks, hired their own helpers, paid the expenses of operating their own trucks, were paid on a per-job basis and did not account to anyone for their time. The court concluded in that situation, the drivers were independent contractors.

Since Silk, the IRS, the Department of Labor, and the courts have tried to create guidelines for understanding the differences between employees and independent contractors. Generally, someone is an independent contractor if their employer has the right to control or direct the end result of their work, but not the means and method of accomplishing that result. Therefore if an employer has the right to direct what will be done by its workers and how it will be done, there is an employer/employee relationship. Some employees are known as “statutory employees.” For those who are not statutory employees, a common law analysis is warranted:

- **Behavioral Control Test.** The more control the company has over how workers perform their work the more likely they are employees. Behavioral control is demonstrated by directing when and where to work; what tools and equipment to use; what assistants may be hired; where to purchase supplies or other services; what work must be performed by the individual rather than delegated; what order or sequence of work to follow; and the level of training provided by the employer to do the job;

- **Financial Control Test.** The more control over the business relationship, the more likely the worker is an employee. Specifically, the courts will look to whether the worker has a personal investment in their tools or their trucks used in the trade, whether they are paid a regular wage, whether they can realize a profit or loss and whether their expenses are reimbursed.

- **Relationship Test.** Other indicators shed light on the type of relationship involved. For example, the existence of a written contract describing the working relationship, the permanency of the relationship and the provision of work benefits.

In addition, if a worker performs services that are integral to the business of the company, it is more likely that the employer will control and direct those activities such that an employer/employee relationship exists. In July 2015, the U.S. Department of Labor, Wage and Hour Division issued a new administrator interpretation of the Fair Labor Standards Act (“FLSA”) definition of employee in a measure designed to collaborate with the IRS. The FLSA test focuses on whether the work performed is integral to the employer's business, whether the worker has an opportunity for profit, whether the worker has any investment risk, whether the work requires special skill and the permanency of the relationship.

Considering the “relationship test” outlined above it is important to comment on the Independent Contractor agreements signed by workers and the impact that agreement might have on determining the
employment relationship. While these types of agreements are relevant as to the intent of the employer and employee, they are not determinative. The IRS has stated this principle in the following Letter Ruling:

A written agreement describing a worker as an independent contractor is viewed as evidence of the parties’ intent to create a non-employee relationship. However, a contractual designation, in and of itself, is not sufficient evidence to base a determination of worker status. It is the substance of the relationship, rather than the label, that governs this determination. PLR 199923014.

The United States Tax Court has followed with a number of decisions which reach a similar conclusion holding that such contracts may be “set aside” if they contradict the common law principles defining the relationship. Therefore, while the agreement is evidence of the type of relationship that was intended, the actual circumstances surrounding the relationship will be controlling and may contradict the agreement.

There is an exception (or two) to every rule and this area of the law provides one. If the worker is able to demonstrate that in a segment of a specific industry there is a long standing practice of treating a certain type of workers as independent contractors they mail prevail. Not an easy task.

There is another exception for that class of persons who are identified as “Statutory Employees” under IRC section 3121(d)(3). Like self-employed individuals, statutory employees can deduct work related expenses above the line and in their entirety on Schedule C. Statutory employees are a limited group and are treated as employees under the Code for the Federal Insurance Contributions Act (FICA, or social security) but not for purposes of IRC sections 62 and 67. Rev. Rul. 90-93, 1990-2 CB 33, IRC Sec(s). 62.

The Lost Deduction for Legal Fees

Legal fees that are incurred by businesses for business purposes reduce AGI and are fully deductible. Legal fees that are incurred for section 212 purposes are deductible subject to the two percent of AGI limit and therefore no longer deductible. So, for example, the loss of the deduction will have a real impact for anyone engaged in litigation with the IRS as the legal fees incurred are no longer deductible. In addition, legal fees that generated income through litigation were deductible subject to the two percent of AGI rule. Now they are no longer deductible.

Before the changes to the tax code, if a taxpayer recovered a court award or settlement, that amount was included in income depending upon the nature of the lawsuit. If the recovery was includable in income then the attorneys’ fees associated with that recovery were deductible subject to the two percent of AGI limitation. Conversely, if the award was not included in income then there would be no deduction for attorney’s fees. With the elimination of deductions subject to the two percent of AGI limitation, taxpayers who have a litigation recovery that is included in income are not going to get a deduction for that portion of the recovery that represents attorneys’ fees. This is particularly significant for contingent fee awards where a percentage of the recovery goes to the attorney who in turn pays tax again on the fee. The result is double taxation of recovery dollars.

The U.S. Supreme Court in Commissioner v. Banks, 543 U.S. 426 (2005) enunciated the general reporting rule on contingency fee arrangements. The client is taxed on the entire amount of a litigation settlement or award, including the portion attributable to the attorney contingent fee. The rationale is the anticipatory assignment of income doctrine, which prevents a taxpayer from diverting income to a third party or creditor without reporting the income. Because the client has ownership over the litigation and the attorney serves as the client’s agent, it is consistent to hold the client as taxable owner of the entire proceeds. Under prior law, the taxpayer could then take a deduction for the amount of attorneys’ fees paid as a miscellaneous itemized deduction. The net result is that the portion of a recovery attributable to an attorney’s contingent fee is taxed twice—first to the litigant and then to the attorney.

Awards for tort-type injuries have been the focus of the courts and the IRS in particular for defining which recoveries are taxable and which are not. IRC Section 104(a)(2) provides an exclusion from income for settlements or awards on account of personal physical injuries or physical sickness but not for emotional distress or punitive damages. Regulations put in place in 2012 removed the prior requirement that a claim be rooted in “tort or tort-type rights” in order to be excluded from income largely because of the statutory necessity of physical injury. At present, the IRC regulations at