Biehl v. Commissioner, 118 T. C. 467 (2002)

In Biehl v. Commissioner, the U. S. Tax Court ruled that a payment made by a former employer directly to an ex-employee's attorney for wrongful termination claims did not qualify as a reimbursement under an accountable plan. This decision means the payment must be included in the ex-employee's gross income and treated as an itemized deduction, potentially increasing their tax liability due to the alternative minimum tax (AMT). The case highlights the strict criteria for reimbursement arrangements under IRC Section 62, impacting how legal fees in employment disputes are taxed.

Parties

Frank and Barbara Biehl (Petitioners) v. Commissioner of Internal Revenue (Respondent). The Biehls were the plaintiffs at the trial level, and the Commissioner of Internal Revenue was the defendant. The case was appealed to the United States Tax Court.

Facts

Frank Biehl was an employee, officer, shareholder, and director of North Coast Medical, Inc. (NCMI), while Barbara Biehl was also a shareholder. In March 1994, the Biehls filed a lawsuit against NCMI and its other shareholders in Santa Clara County, California, Superior Court. The lawsuit included a claim for wrongful termination of Frank Biehl's employment and a claim for dissolution of NCMI. Following a jury verdict of $2. 1 million in favor of Frank Biehl on his wrongful termination claim, the parties negotiated a global settlement in December 1996. Under the settlement, NCMI paid $799,000 directly to Frank Biehl and $401,000 directly to the Biehls' attorney. The Biehls did not report the $401,000 payment to their attorney on their 1996 tax return, arguing it was a reimbursement under an accountable plan.

Procedural History

The Biehls filed a petition in the United States Tax Court challenging the Commissioner's determination of a $97,833 deficiency in their 1996 federal income tax. The Commissioner argued that the $401,000 payment to the Biehls' attorney should be included in their gross income and treated as a miscellaneous itemized deduction, subject to the 2% floor and disallowed for AMT purposes. The case was submitted to the Tax Court fully stipulated under Rule 122. The Tax Court held for the Commissioner, ruling that the payment did not qualify as a reimbursement under an accountable plan.

Issue(s)

Whether the payment made by NCMI directly to the Biehls' attorney for wrongful termination claims qualifies as a reimbursement under a "reimbursement or other expense allowance arrangement” as defined in IRC Section 62(a)(2)(A) and (c), allowing it to be excluded from gross income or deducted in arriving at adjusted gross income?

Rule(s) of Law

IRC Section 62(a)(2)(A) allows a deduction from gross income in arriving at adjusted gross income for expenses paid or incurred by an employee in connection with the performance of services as an employee under a reimbursement or other expense allowance arrangement with the employer. To qualify as an accountable plan under Section 62(c), the arrangement must satisfy three requirements: (1) the expense must be deductible under Section 162(a); (2) the employee must substantiate the expenses to the employer; and (3) the employee must return any excess amounts to the employer. The regulations under Section 62(c) incorporate the “business connection” requirement of Section 62(a)(2)(A), requiring the expense to be incurred by the employee in connection with the performance of services as an employee of the employer.

Holding

The Tax Court held that the payment made by NCMI directly to the Biehls’ attorney did not qualify as a reimbursement under an accountable plan. The court concluded that the payment failed to satisfy the “business connection” requirement of IRC Section 62(a)(2)(A) and the accountable plan regulations, as it was not incurred in connection with the performance of services as an employee of NCMI. Therefore, the payment must be included in the Biehls’ gross income and treated as a miscellaneous itemized deduction.

Reasoning

The court’s reasoning focused on the interpretation of the “business connection” requirement under IRC Section 62(a)(2)(A) and the accountable plan regulations. The court emphasized that a reimbursed expense must be incurred by an employee on behalf of the employer during the course of an ongoing employment relationship. The payment to the Biehls’ attorney was not incurred in connection with the performance of services as an employee of NCMI, as Frank Biehl was no longer employed by NCMI when the expense was incurred. The court rejected the Biehls’ argument that the settlement agreement and shareholders agreement constituted a reimbursement arrangement, finding that these agreements did not establish a connection to the performance of services as an employee. The court also noted the absence of any evidence that NCMI instructed Frank Biehl to incur the attorney’s fee on its behalf or that the payment served a business purpose of NCMI. The court acknowledged the potential injustice of the result but concluded that the plain meaning and original intent of Section 62(a) required the holding.

Disposition

The Tax Court entered a decision for the Commissioner, sustaining the determination that the $401,000 payment to the Biehls' attorney must be included in their gross income and treated as a miscellaneous itemized deduction.

Significance/Impact

Biehl v. Commissioner clarifies the strict criteria for reimbursement arrangements under IRC Section 62, particularly the "business connection" requirement. The decision has significant implications for former employees seeking to exclude payments for legal fees from gross income, as it establishes that such payments must be made during an ongoing employment relationship and for the benefit of the employer. The case also highlights the potential tax consequences of treating legal fees as itemized deductions, including the impact of the 2% floor and the alternative minimum tax. Subsequent cases and regulations have followed the reasoning in Biehl, reinforcing the importance of the business connection requirement in determining the tax treatment of reimbursed expenses.