When Plaintiffs in Class Actions Pay Tax on Attorneys' Fees

In *Banks*, 543 U.S. 426 (2005), the Supreme Court held that contingent attorneys' fees generally represent income to the plaintiff, even if the fees are paid directly to the lawyer without passing through the plaintiff's hands. The Court announced this only as a general rule, carving out several substantive issues it did not address. For example, the Court did not address the tax treatment of attorneys' fees in cases involving injunctive relief or statutory fee-shifting provisions. More important, *Banks* was silent on class action attorneys' fees, leaving unanswered the big question of whether amounts paid to class counsel are income to class members.

If attorneys' fees do represent income to the plaintiffs, then deducting them may not be easy. In 2004, Congress eked out a partial reform concerning the deductibility of attorneys' fees in employment and certain other cases (Sec. 62(a)(20), added by the American Jobs Creation Act, P.L. 108-357, §703). Yet, outside the employment litigation arena, if plaintiffs are attributed income measured by the amount of attorneys' fees their counsel receives, there

is often no way to deduct them. In effect, the plaintiffs pay tax on money they never see. The problem can be particularly acute in class actions, where counsel fees may be out of proportion to the net amount each class member receives.

Prior to *Banks*, there was a split in the circuit courts. A majority of circuits had held that contingent attorneys' fees constituted gross income to both the plaintiff and the attorney. (See *Alexander*, 72 F.3d 938 (1st Cir. 1995); *Raymond*, 355 F.3d 107 (2d Cir. 2004); *O'Brien*, 319 F.2d 532 (3d Cir. 1963); *Young*, 240 F.3d 369 (4th Cir. 2001); *Kenseth*, 259 F.3d 881 (7th Cir. 2001); *Bagley*, 121 F.3d 393 (8th Cir. 1997); *Benci-Woodward*, 219 F.3d 941 (9th Cir. 2000); *Coady*, 213 F.3d 1187 (9th Cir. 2000); *Sinyard*, 268 F.3d 756 (9th Cir. 2001); *Hukkanen-Campbell*, 274 F.3d 1312 (10th Cir. 2001); and *Baylin*, 43 F.3d 1451 (Fed. Cir. 1995).)

A minority of circuits had held that the fees were not income to the plaintiff, only to the attorney. (See *Cotnam,* 263 F.2d 119 (5th Cir. 1959); *Estate of Clarks*, 202 F.3d 854 (6th Cir. 2000); *Davis*, 210 F.3d 1346 (11th Cir. 2000); *Srivastava*, 220 F.3d 353 (5th Cir. 2000); *Banaitis*, 340 F.3d 1074 (9th Cir. 2003); and *Banks*, 345 F.3d 373 (6th Cir. 2003).) This split created disparate results in different circuits, with some plaintiffs escaping tax on the attorneys' fees and some not.

Banks made it worse for plaintiffs. For those who are caught by *Banks*'s general rule and must therefore include counsel fees in their income, the deduction choices may include:

- An above-the-line deduction now provided by Sec. 62, but only in employment cases and federal False Claims Act cases;
- A trade or business expense deduction (perhaps on Schedule C) if the litigation can fairly be attributed to the conduct of a trade or business;
- A miscellaneous itemized deduction, subject to a 2% adjusted gross income threshold, various phaseout rules, and nondeductibility for purposes of the alternative minimum tax; and
- No deduction at all if the litigation is purely personal.

The third possibility in the above list (miscellaneous itemized deduction) is probably the most common, and it results in a large number of unhappy plaintiff-taxpayers every year.

The Supreme Court in *Banks* clarified that a taxpayer must "generally" include in gross income the portion of taxable damages paid to his or her attorney as attorneys' fees. This is true even if the defendant makes payment directly to the taxpayer's attorney (*Banks*, 543 U.S. 426 (2005); see also *Old Colony Trust Co.*, 279 U.S. 716 (1929)). However, *Banks* implied that there would be situations in which attorneys' fees would not be includible in a claimant's gross income.

Unfortunately, the Court only hinted at exceptions. The Court suggested that its general rule should not apply to cases in which statutory fees are available or an injunction is sought. Unfortunately, it is not clear if the Court meant cases in which the injunction is the major part of the case, the only part of the case, or something else.

Opt-Out Versus Opt-In Cases

A class action can be either an opt-out or opt-in case. The difference is more than semantics: The tax consequences to class members can be quite different. In an opt-out case, no class member (other than the class representative) will generally execute a fee agreement with class counsel. Moreover, potential class members generally need take no action to be considered part of the class. A class member obtains the benefits of class membership merely by coming within the defined class.

In a typical opt-out class action, the precise composition of the class is not known. Class counsel often will reserve a portion of the fund for class members who may later be identified. For example, a class representative might sue his former employer on behalf of all similarly situated employees who held positions at a defendant company during a stated period. Because of the uncertainty of locating all class members, class counsel may reserve funds for payment to class members not yet identified by the settlement payment date.

In an opt-out lawsuit, a class member has the right and the power to affirmatively exclude himself from the class prior to a date set by the court. (See *Eirhart v. Libbey-Owens-Ford Co.*, 726 F. Supp. 700 (N.D. Ill. 1989).)

The characteristics of an opt-out class action are in sharp contrast to those of an opt-in action. In an opt-in class action, all members must affirmatively join the class, and each class member must execute (or otherwise acquiesce in) a fee agreement with class counsel. When the class is closed by the court, all class plaintiffs will have been identified. (See *Sinyard*, T.C. Memo. 1998-364, aff'd 268 F.3d 756 (9th Cir. 2001).)

This opt-in versus opt-out character affects more than just tax issues, but the tax issues are huge. The most important federal income tax distinction between these two types of class actions concerns the inclusion of attorneys' fees. It is usually possible to worry about this tax issue only in opt-in cases, where the connections between class counsel and clients is stronger. In an opt-in class action, each class member may have gross income in the amount of his or her proportionate share of attorneys' fees. This tax rule is grounded in each class member's contractual agreement to pay legal fees. (See *Sinyard*, 268 F.3d at 758.)

Knowledge and Fee Agreements

Some commentators have suggested that the tax issue is based on the defendant's knowledge of the class members' identity. After all, the defendant in an opt-in case is likely to be able to ascertain the identity of all members in an opt-in class action. However, the Ninth Circuit in *Sinyard* plainly states that the inclusion of attorneys' fees in an opt-in class action is based solely on a contractual obligation theory.

In contrast, in an opt-out class action, class members are typically not required to include their share of attorneys' fees in their respective gross incomes. The theory for excluding those fees in such a case is that when fees are awarded, "not all members of a class have become identified or contractually obligated to compensate" class counsel (*Sinyard*, T.C. Memo. 1998-

364 at 15). However, the Service has consistently taken the position that the identification of class members is not important in assessing the income tax treatment of the opt-out class members.

The IRS has issued numerous private letter rulings, consistently ruling that payments made to class counsel in an opt-out class action are not income to the class members. (See Letter Rulings 200518017, 200344022, 200340004, 200316040, 200222001, 200106021, and 200025023.) The IRS relies on Rev. Rul. 80-364, Situation 3, as support for the proposition that attorneys' fees do not represent gross income to class members. The IRS focuses solely on the fact that class members in an opt-out class action have no contractual relationship with class counsel. (See also Letter Rulings 200551008 and 200518107.)

Furthermore, in Chief Counsel Advice (CCA) 200246015, the IRS chief counsel said, "Legal fees paid directly to class counsel are not income, profits, or gain to a taxpayer if the taxpayer does not have a separate contingency fee arrangement with the class counsel and the class action is an opt-out class action." The CCA cites the following for this proposition: *Sinyard; Frederickson,* T.C. Memo. 1997-125, aff'd in unpub. opinion, 166 F.3d 342 (9th Cir. 1998); and Rev. Rul. 80-364, Situation 3.

Post-*Banks* Rulings

Although the Supreme Court in *Banks* did not deal with class action attorneys' fees, there has been some comfort since then. The IRS's rulings since *Banks* demonstrate that the Service does not believe the Supreme Court's decision changed the law on this point. In four letter rulings on this topic since *Banks* was decided, the IRS has ruled that attorneys' fees paid to class counsel in an opt-out class action were not income to class members (Letter Rulings 200625031, 200610003, 200609014, and 200551008).

In other words, the IRS clearly believes that the general rule of *Banks* does not apply, at least to opt-out class actions. In all four rulings, the lack of a contract between the class members and the class counsel was critical. For example, Letter Ruling 200340004 dealt with an opt-out class action alleging unlawful compensation practices.

Prior to class certification, class representatives entered into a retainer agreement entitling class counsel to a one-third contingency fee if the action proceeded without class certification. After the class was certified, the court awarded attorneys' fees equal to 20% of the settlement. The court disregarded the contingency fee arrangement to which the attorneys would have been entitled if the action had proceeded without class certification. Under these facts, the IRS ruled that the payments made to class counsel were not gross income to class members.

The IRS's private letter rulings dealing with class actions cite *Sinyard* and *Frederickson* as "but see" authorities, contrasting them with the rulings. Although *Sinyard* involved a class action, it was an opt-in case. There, the court held that attorneys' fees paid to class counsel constituted gross income to Sinyard because he had entered into a contingency fee agreement with class counsel.

This suggests that a class member (who is not a class representative) could have gross income in an opt-out class action if he or she signs a fee agreement with class counsel. Although *Frederickson* involved a class action, the court does not state whether the underlying case was an opt-in or an opt-out action. However, Frederickson personally entered into the agreement to compensate class counsel, so it is not surprising that the court held Frederickson had gross income on the attorneys' fees.

Reporting

A discussion of gross income and attorneys' fees would be incomplete without at least a brief mention of the reporting requirements for such payments. Indeed, reporting issues often start the debate on this topic. Plaintiffs' counsel will often ask defendants to ensure that attorneys' fees are not reported (on Forms 1099) to the class for tax purposes.

As a general rule, Sec. 6041 requires all persons engaged in a trade or business and making payments of $600 or more in any tax year to file a Form 1099 with the IRS (Regs. Sec. 1.6041-1). Moreover, there are now specific Form 1099 rules that generally require defendants to double report payments to lawyers. The idea is that both the plaintiff and the plaintiff's counsel should receive a Form 1099 for the legal fees, even if the plaintiff's counsel is paid directly by the defendant. (See Sec. 6045(f) and accompanying regulations.) Generally, though, if it is clear that the attorneys' fees are excludible from the plaintiff's gross income, the defendant would not be under an obligation to issue the Form 1099 to the plaintiff.

The question is whether defendants and/or law firms as payors in a class action need to issue Forms 1099 to class members for the legal fees. Attorneys' fees typically should not be includible in the gross income of class members in an opt-out case. Consequently, the payments of attorneys' fees to class counsel in an opt-out case should not be reportable to class members on Form 1099. (See *Eirhart*, 726 F. Supp. at 706.)

This conclusion conforms to the numerous private letter rulings in which payments to class counsel for attorneys' fees were determined not to constitute gross income to class members (Letter Rulings 200625031, 200610003, 200518017, 200344022, 200340004, 200316040, 200222001, 200106021, and 200025023). These rulings also state that the attorneys' fees were not subject to the reporting requirements of Sec. 6041 with respect to class members.

In opt-in cases, in contrast, the presumption will often be that class members have income on counsel fees, so many defendants will issue Forms 1099 that include the counsel fees. In opt-in cases, further thoughts and planning regarding these tax issues are usually required.

Conclusion

The taxation of attorneys' fees in opt-out class actions has become relatively clear, as long as certain elements are established. In opt-in cases, class members risk being tagged with income in the amount of the attorneys' fees. With opt-out cases, the class members should be free of the taint of attorneys' fees. Opt-out cases generally do not involve tax problems provoked by the attorneys' fees. In contrast,

considerable attention, energy, and worry should be focused on the tax issues present in opt-in cases.

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