Attorney Fees in Class Actions
When Plaintiffs Are Taxed Too

By Robert W. Wood

Are legal fees paid to class counsel taxable income to plaintiffs in a class action? For example, suppose a class member receives $1,000 from a case. That plaintiff will be displeased if he or she receives a cash award of only $1,000 but is given an IRS Form 1099 reporting that $1,500 is taxable (because of the tax on the plaintiff’s pro rata share of attorney fees). Paying tax on money you don’t receive is never pleasant. Unfortunately, in Commissioner v. Banks, 543 U.S. 426 (2005), the Supreme Court held contingent attorney fees generally represent income to the plaintiff.

The big tax question is whether amounts paid to class counsel are income to class members. It’s an issue of considerable magnitude.

If attorney fees do represent income to the plaintiffs, then deducting them may not be easy. In 2004, through Public Law No. 108-357, section 703, Congress eeked out a partial reform concerning the deductibility of attorney fees in employment and certain other cases. Yet, outside the employment litigation arena, if a plaintiff is attributed income measured by the amount of attorney fees his or her counsel receives, there is often no decent way to deduct them. In effect, the plaintiff pays tax on money never seen. The problem can be particularly acute in class actions, where counsel fees may be all out of proportion to the net amount each class member receives.

Prior to Banks, there was a bitter dispute in the circuit courts. A majority of circuits had held that contingent attorney fees constituted gross income to both the plaintiff and the attorney. The minority circuits had held the fees were not income to the plaintiff, only to the attorney. This created disparate results in different circuits, with some plaintiffs escaping tax on the attorney fees, and some not.

What had been a hodgepodge of tax decisions was made only worse by the Banks decision. For plaintiffs who are caught by Banks’ general rule and must therefore include counsel fees in their income, the deduction choices may include

• an above-the-line deduction, but only in employment cases and federal False Claims Act cases;
• a trade or business expense if the litigation arises out of the conduct of their trade or business;
• a miscellaneous itemized deduction, subject to a 2 percent adjusted gross income threshold, various phase-out rules, and nondeductibility for purposes of the alternative minimum tax;
• no deduction at all if the litigation is purely personal.

Miscellaneous itemized deduction treatment is the most common, and results in a great number of unhappy plaintiffs every year. In an employment case, whether a one-off suit or a class action, there is a special tax deduction that, in effect, nets the recovery and the legal fees. So fortunately, you need read no further if your case (even a class action) is an employment case. Everyone else, read on.

Opt-in versus Opt-out

To address attorney fees in class actions, it is important to start with a little nomenclature. A class action can be either an opt-out or opt-in case, and the difference is more than semantics. 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—you obtain 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. 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 to affirmatively exclude oneself from the class prior to a date set by the court.

In an opt-in class action, you have to affirmatively do something to become a part of the case. There will be a claims procedure, and a plaintiff will not become a part of the case and be bound by it unless he or she affirmatively elects to “opt in” to the case and its settlement. Frequently, by affirmatively agreeing to participate in the case and its settlement, the plaintiff also is agreeing to compensate the class

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counsel. Indeed, by electing to join the class, each class member must generally execute (or otherwise acquiesce in) a fee agreement with class counsel.

This opt-in versus opt-out character affects more than just tax issues, but the tax issues are huge. The most important tax distinction between these two types of class actions concerns the tax treatment of attorney fees. Fortunately, it is usually possible to worry about this tax issue only in opt-in cases. In an opt-in case, each class member usually has gross income not only on the cash that the member receives, but also for his or her proportionate share of attorney fees. This tax rule is grounded in each class member’s contractual agreement to pay legal fees.

In contrast, in an opt-out class action, class members are typically not required to include any share of attorney fees in their gross incomes. They get taxed only on what they receive. The theory for excluding attorney 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.

Common Fund Theory
Much of the class action attorney fees law revolves around the question whether counsel will be paid from a so-called common fund. The common fund doctrine has a long history, reflecting traditional practice in courts of equity. In the nineteenth century, the U.S. Supreme Court in Trustees v. Greenough, 105 U.S. 527 (1882), recognized that a litigant (or a lawyer) who recovers a common fund for the benefit of persons other than oneself (or his or her client) is entitled to a reasonable attorney fee from the fund as a whole.

This common fund doctrine stands as a recognized exception to the so-called American rule that every litigant must bear his or her own attorney fees. This American rule contrasts with the British rule, under which losers in litigation generally must pay the prevailing party’s legal fees. Common fund lore rests on the principle that persons who obtain the benefit of a successful lawsuit without contributing to its cost will be unjustly enriched at the successful litigant’s expense. Thus, courts typically retain jurisdiction over a fund produced by a class action, effectively preventing inequity by assessing attorney fees against the entire fund. This has the effect of spreading the impact of the attorney fees that produced the fund proportionately among those who benefited by the suit.

Post-Banks Rulings
Although the Supreme Court in Banks did not explicitly address class action attorney fees, there have been a number of helpful IRS rulings since then that give greater tax certainty to this area. The IRS’s rulings since Banks demonstrate that the IRS does not believe the Supreme Court’s decision changed the law on this point. In four private letter rulings (PLR 200625031; PLR 200610003; PLR 200609014; and PLR 200051008), the IRS ruled that attorney fees paid to class counsel in an opt-out class action were not income to class members.

The IRS ruled that the payments made to class counsel were not gross income in an opt-out class action if that member signs a fee agreement with class counsel. The presence of such authority is troubling, suggesting that a rigid focus on the opt-out nature of a case could be shortsighted, at least where there is a written fee agreement signed by the taxpayer that might be seen as trumping the normal rule that plaintiffs in an opt-out case don’t have income when class counsel are paid.

Knowledge and Fee Agreements
Some commentators have suggested that the tax issue is based on the defendant’s knowledge of the identity of the class members. 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 attorney fees in an opt-out 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 attorney fees in their respective gross incomes. The theory for excluding attorney 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. Oddly enough, the seminal case on this point is a district court decision, Eirhart v. Libbey-Owens-Ford Co., 726 F. Supp. 700 (N.D. Ill. 1989), which established a two-part test: not all class members are identified, or not all class members are contractually obligated to compensate class counsel.

In Eirhart, an action to which the IRS was not a party, the court held that separately deposited funds paid to the
opt-out class members’ lawyers in settlement of claims arising under Title VII did not result in gross income to the class members. In most class actions, both tests set forth in Eirhart will have been met. Yet, in what evidently is a taxpayer-friendly test, the court in Eirhart states the test in the disjunctive. Thus, only one of the two Eirhart tests should need to be met in order for the attorney fees to be excludable from the class members’ gross incomes.

In my experience, the latter test (not signing a fee agreement) is virtually always met. Only the class representative will generally have executed a fee agreement with class counsel. Despite the alternative tests in Eirhart, the Internal Revenue 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. The IRS relies on Revenue Ruling 80-364 (1980-2 C.B. 294, Situation 3) as support for the proposition that attorney 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.

Furthermore, in Chief Counsel Advice 200246015 (a legal memorandum from the IRS Chief Counsel’s Office), the IRS Chief Counsel said that []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.

**IRS Forms 1099**

The IRS’s tax reporting and matching schemes have become ever more comprehensive and even Byzantine. As a general rule, all persons engaged in a trade or business and making payments of $600 or more must file a Form 1099 reporting payments to the IRS. Moreover, there are now specific Form 1099 rules that generally require defendants to double report payments to lawyers. When a case is settling, plaintiffs’ concerns about tax-reporting issues often trigger the debate on the subject of taxation, and particularly on the tax treatment of attorney fees. Plaintiffs’ counsel will often ask defendants to ensure that attorney fees are not reported (on Forms 1099) to the class members for tax purposes.

The idea of double reporting payments to lawyers is for both the plaintiffs and the plaintiffs’ counsel to receive a Form 1099 for legal fees. This is generally required even if the plaintiffs’ counsel is paid directly by the defendant. Generally, though, if the attorney fees are excludable from the plaintiffs’ gross income, the defendant is under no obligation to issue a Form 1099 to the plaintiffs.

Recall that attorney fees typically should not be includable in the gross income of class members in an opt-out case. That means the payments of attorney fees to class counsel in an opt-out case should not be reportable to class members on Form 1099. In opt-in cases, in contrast, the usual presumption is that class members will have gross income on their pro rata share of counsel fees. That means many defendants will issue Forms 1099 that include the counsel fees.

If you have an opt-in case, special planning regarding these tax issues is usually required. Many plaintiffs’ counsel will want to explain to class members in a class mailing how class members can deduct the fees. In some limited situations, there may be ways of mitigating or eliminating this tax issue for class members even in opt-in cases. Yet, at a minimum, considerably more in the way of explanations and disclosures to the plaintiffs’ class are called for.

**Conclusion**

In opt-in cases, class members risk being tagged with income in the amount of the attorney fees. With opt-out cases, the class members should generally be free of the taint of attorney fees. Opt-out cases generally don’t involve tax problems provoked by the attorney fees. In contrast, considerable attention, energy, and worry should accompany tax issues in opt-in cases.

Be careful out there!