Should Employers Withhold on Attorney Fees?

By Robert W. Wood


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When a contingent fee employment lawsuit settles and the recovery is solely wages to one or more plaintiffs, how should — and how do — employers treat the payment of contingent legal fees? Wood reviews and updates the authorities affecting this problem, because withholding on the legal fees paid to plaintiff's counsel is impracticable.

In 2005's *Commissioner v. Banks*,[1] the Supreme Court resolved a deep split in the circuits over the tax treatment of attorney fees. The question was whether the fees paid by a successful plaintiff to his contingent fee attorney represent income to the plaintiff himself. Often the attorney fees are paid directly to the lawyer.

Taxpayers took the position that they should not have to include the attorney fees in income, which (in most cases) they never even received. The plaintiffs in *Banks* advanced several theories why they should not be taxed on what their lawyer receives. Nevertheless, the Court held as a general rule that the fees constitute income to the client.

The case gave rise to much consternation. The share paid to the attorney can be seen as an assignment of income. Also, the client signing a fee agreement has a debt to the lawyer. For those and other reasons, the Supreme Court is probably correct that the legal fees should generally be income to the client. Yet, the exceptions to that rule and how they should be addressed is less clear. The tax problems for plaintiffs have not gone away.

Banks: Too Much and Too Little

It is the cases that do not follow the general rule that are difficult to resolve. Despite a plethora of amicus briefs, the Supreme Court did a lackluster job of explaining how and when the general rule would not apply. Even class actions are in a kind of middle ground, although for a variety of reasons, attorney fees in class actions are usually not attributed to class members.[2]

In effect, the Court in *Banks* may have said too much and too little. Famously, the Court left open the possibility of multiple exceptions to its harsh result. There has been little discussion since then of those exceptions and their scope. But it is now generally accepted that unless one is creative, lucky, or both, the fees paid to a contingent fee lawyer will be gross income to the client even if paid directly to the lawyer.

That means the client will want to find a way to deduct the fees. Otherwise, he is paying tax on money he never sees. That is how clients see the issue, one they find quite inequitable. In the real world, not all deductions are created equal.

An above-the-line deduction was enacted by statute in late 2004, just months before the Supreme Court decided *Banks*.[3] In fact, the passage of that law was unsuccessfully urged upon the Court as a reason it did not need to decide *Banks*. The above-the-line deduction for fees in employment cases means that in employment litigation, no one seems to care now whether the client has gross income on the attorney fees. That is logical. As long as the client can claim the above-the-line deduction, there is no harm.

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[1]543 U.S. 426 (2005), *Doc 2005-1418, 2005 TNT 15-10.*

[2]*See* Robert W. Wood, "Attorney Fees in Class Actions When Plaintiffs Are Taxed Too," 18 *Bus. L. Today* 1 (Jan./Feb. 2009), *available at* http://www.WoodLLP.com/Publications/Articles/pdf/BLT_JanFeb09_wood_.pdf.

[3]*See* section 703 of the American Jobs Creation Act of 2004 (P.L. 108-357).

Weighty Wage Worries

What happens when the case is *solely* a wage case? Nearly all employment cases seem to have a mix of claims, including claims for wages, nonwage but taxable damages, fringe benefits, emotional distress, and sometimes even physical injuries or physical sickness.[4] There are usually multiple statutes alleged to have been violated, and often multiple nonstatutory claims.

When resolving a lawsuit involves such a potpourri of claims, it is generally possible in a settlement agreement to allocate the claims and the settlement dollars across a range of payments. There could be some wages subject to withholding and reported on a Form W-2. There could be some Form 1099 income not subject to withholding, some attorney fees and costs, and some nontaxable benefits. There can even be some damages for personal physical injuries or physical sickness that are not gross income and therefore should not be the subject of a Form 1099.

However, what of the *pure* wage claim? By statute, some employment claims can yield only 100 percent wages. Specific claims under the Fair Labor Standards Act may be the best example.[5] Settling such a case is easy, since there can be no argument about any of the other categories of damages. Wages are wages. If the employees are paid $1 million, it is all subject to wage withholding.

Yet, if there are contingent fee plaintiffs' lawyers involved, what about their fees? The fact that an above-the-line deduction would be available for their fees is unhelpful. Returning to the general rule enunciated in *Banks*, could the fees be considered wages of the clients (who were employees) even if paid directly to the lawyers? So it would seem.

Unless the 100 percent wage claim is an exception to the general rule of *Banks* (which seems doubtful), the theory of *Banks* suggests that the employer should withhold. That is, if the fees are the client's gross income, and if the *only* gross income the client is receiving in the case is wages, the attorney fees could also be wages. Could the attorney fees therefore also be subject to withholding as wages? The answer should surely be no from a simple practical position, but the analysis is troubling.

Prior Attorney Fee Guidance

Despite its age, the best guidance on this issue remains Rev. Rul. 80-364.[6] There, the IRS considered whether attorney fees and interest awarded with back pay are wages for employment tax purposes. The ruling describes three situations.

In Situation 1, after termination of employment by a company, an individual filed a complaint for back pay. The court awarded the individual $8 in back pay, $1 in attorney fees, and $1 in interest. The ruling concludes that although the entire $10 is includable in gross income, only the back pay award of $8 is wages for federal employment tax purposes. Notably, the IRS has extended that rationale to when there is no court award of attorney fees. However, the claim settled must be the type of claim for which the court would have awarded attorney fees.[7]

In Situation 2 of Rev. Rul. 80-364, an individual sues his employer for $15 for back pay. Under a court order, the employer paid the individual $10. The court order did not indicate that a portion of the award was for attorney fees or interest. The employee paid $1 in attorney fees. The revenue ruling provides that the full amount of the award is income to the employee and is also wages for federal employment tax purposes.

In Situation 3, a union files a claim against a company on behalf of the union members for breach of a collective bargaining agreement. The union and the company entered into a settlement agreement, later approved by a district court, which provided that the company would pay the union $40 in settlement of all claims. The union paid $6 of the settlement for attorney fees and returned $34 to the employees for back pay owed to them. The back pay was distributed to the employees in proportion to their claims. The ruling indicates that the attorney fees paid by the union are not remuneration for employment and thus are not wages. Also, the ruling concludes that the attorney fees are not includable in the employees' gross income.

Latest Wage Wallop

In July 2009, the IRS provided a review of Rev. Rul. 80-364 and the wage treatment for attorney fees more generally. In PTMA 2009-035,[8] the IRS recites the different factual situations analyzed in Rev. Rul. 80-364. The IRS acknowledges that most

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[4]*See Parkinson v. Commissioner*, T.C. Memo. 2010-142, *Doc 2010-14364, 2010 TNT 124-12*; *Domeny v. Commissioner*, T.C. Memo. 2010-9, *Doc 2010-787, 2010 TNT 9-9.* For more extensive discussion of *Domeny*, see Wood, "Is Physical Sickness the Next Emotional Distress?" *Tax Notes*, Feb. 22, 2010, p. 977, *Doc 2010-2454*, or *2010 TNT 37-11.*

[5]*See, e.g.*, section 216.

[6]1980-2 C.B. 294.

[7]TAM 200244004, *Doc 2002-24564, 2002 TNT 213-18.*

[8]*Doc 2009-15305, 2009 TNT 129-19.* Although the program manager technical assistance was released in July 2009, it bears a date of October 22, 2008. For further discussion, see Wood, "IRS Speaks Out on Employment Lawsuit Settlements," *Tax Notes*, Sept. 14, 2009, p. 1091, *Doc 2009-18678*, or *2009 TNT 175-4.*

employment-related disputes are settled rather than tried. The memo then states:

> Whether attorneys' fees recovered in a settlement of an action under a fee-shifting statute are excluded from wages is an open question. For example, if a suit for back pay under Title VII is settled, and provides for back pay and attorneys' fees in the settlement agreement, the question arises whether the portion of the settlement characterized as attorneys' fees is wages.[9]

The memo states that if this issue arises, the IRS National Office should be contacted for guidance. That is disturbing, since few people in practice suggest that the plaintiff's attorney fees in even a strictly wage case should be treated as wages. The IRS seemingly would also want to avoid that result.

In fact, in TAM 200244004,[10] the IRS addressed wage treatment for attorney fees related to an employment discrimination suit brought under the Age Discrimination in Employment Act (ADEA). The Service acknowledged that the ADEA contains a fee-shifting component. Under the analysis in Rev. Rul. 80-364, had the employee prevailed in litigation under the ADEA, he would have received an award of attorney fees in addition to the back wage award.

TAM 200244004 concludes that the attorney fees paid under a settlement agreement in such an employment suit are not wages for federal employment tax purposes. How far that rationale should extend is unclear.

Examples of Fee Fiascos

To state the pure analytical case, consider a lawsuit (brought by one person or many) that seeks *only* wages, with no other types of damages. Such suits are rare, but they do occur (some Fair Labor Standards Act cases, for example, are of this ilk). If the plaintiff will receive 100 percent wages, and the lawyer is being paid a contingent fee of 40 percent, how is the employment and income tax withholding to be accomplished?

The choices would seem to be:

> 1. Withhold on the client's share only, and pay the lawyer his gross 40 percent fee with no withholding.
>
> 2. Withhold on 100 percent, thus shortchanging the lawyer. That would doubtless require continued relations between client and lawyer into the following tax year, with the lawyer having a claim on monies withheld and paid over to the IRS.
>
> 3. Withhold only on the client's 60 percent, but at a rate (for both income and employment tax purposes) that takes into account the 40 percent being paid to the lawyer. The idea would be to attribute the income (as wages) to the client, as if the client were really receiving the full 100 percent, but to allow the lawyer to receive his full 40 percent share not reduced by withholding.

Choices 2 and 3 seem impracticable. For example, query how the plaintiff would deduct the legal fees. Even an above-the-line deduction would not make the plaintiff whole. Quite apart from the timing problem created by withholding, how could the plaintiff recover his share of the employment taxes on the lawyer's 40 percent contingent fee? These are interesting questions.

Future Fee Fixes?

However, shorn of hypotheticals and faced with the imperfect realities of real life, what would happen? It seems unlikely that the parties in a real case would select choice 2 or choice 3. In fact, in my experience it is rare for an employer in a wage case to even raise the potential need to withhold on the lawyer's share of the funds. I believe employers do not want to raise the issue. It is awkward and counterintuitive, because withholding is plainly unworkable.

But in the few cases in which I have seen such an issue even raised, I have also seen each employer back off and agree not to withhold. They might so agree based on an analytical argument derived from TAM 200244004. That is, even if this is a 100 percent wage case, and even assuming the *Banks* rule that fees paid to counsel are in effect first paid to the client, those fees also can't be wages, as this technical advice memorandum suggests.

In a class action, another possibility is that the defendant can be convinced (or can convince itself) based on the class action tax authorities that the fees should not count as income to the clients (and therefore cannot be wages). However, the class action authorities often distinguish between opt-in and opt-out cases. The former are more likely to result in legal fees being attributed to the class.

Yet historically (and sensibly), the IRS has often done its best to avoid the untoward result of plaintiffs in class actions having income on the legal fees. Otherwise, each class member may receive a relatively small amount of money but wind up tagged with a pro rata portion of the legal fees paid to class counsel, which can be much more. The numbers can be quite skewed.

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[9]PTMA 2009-035 at 12.
[10]*See supra* note 7.

Finally, the employer might decide not to withhold on the attorney fees because the plaintiff's counsel simply says unabashedly to the employer: "If you withhold on the lawyer fees, too, this case will not settle." To an employer that needs to get a case settled, that put-up-or-shut-up position can be a potent argument.

The last time I wrote about this topic, Jared Mobley thoughtfully suggested that the employer's withholding obligation should not be ignored and that the risks to an employer in this circumstance may be larger than I suggested.[11] He may be right, although even if he is, the practical problem remains. How can an employer possibly withhold?

The lawyer will surely not consummate the settlement if Choice 2 is used. Choice 3 takes all the withholding from the client's share. Mathematically that may mean the client(s) get very, very little. The clients are unlikely to go along with this.

Conclusion

Most companies are probably not too concerned about their exposure to penalties if they fail to withhold on the attorney fees. In all likelihood, the companies are far more afraid of failing to settle the lawsuit. For me (and, I suspect, for many employers and the tax lawyers who represent them), it is hard to imagine the IRS pushing this issue in an audit.

Nevertheless, how to treat contingent legal fees in a 100 percent wage case represents an interesting analytical conundrum. As a practical matter, it is rarely discussed. Unless the IRS intends to issue additional guidance outlining its position on the treatment of these fees, it may be appropriate for plaintiffs in wage disputes, the companies they sue, and their respective attorneys to exercise caution in this area.

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[11] *See* Mobley, "Attorney Comments on Employment Lawsuit Settlements Article," *Tax Notes*, Sept. 28, 2009, p. 1387, *Doc 2009-21097*, or *2009 TNT 185-19*; *see also* Wood, "Wood Responds to Critique of His Article," *Tax Notes*, Oct. 5, 2009, p. 155, *Doc 2009-21525*, or *2009 TNT 190-11*.