Opt-In, Opt-Out Hopscotch Over Taxes in Class Actions

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Tax issues surrounding attorney fees affect nearly all settlements and judgments, as well as nearly all plaintiffs and defendants, and can affect both deductions and inclusions. Not surprisingly, this pervasive regime has slowly morphed into a spider web of entanglement. Indeed, some attorney fees issues have found an ear at the highest levels of our legislative and judicial branches. In 2004 Congress eked out a partial reform for tax problems over the deductibility of attorney fees for employment cases and some other claims.[1]

Just months later, in January 2005, the Supreme Court had the opportunity in *Banks*[2] to resolve a historic split among the circuits. In part, the Court did so, and, in part, the Court left us hanging. Before *Banks*, a majority of circuits had held that contingent attorney fees constituted gross income to the plaintiff and to the attorney.[3] The minority had held that the fees were not income to the

[1]*See* P.L. 108-357, section 703 (Oct. 22, 2004). *See* Robert W. Wood, ''Jobs Act Attorney Fee Provision: Is It Enough?'' *Tax Notes*, Nov. 15, 2004, p. 96, *Doc 2004-21482*, *2004 TNT 215-27*.

[2]*Commissioner v. Banks*, 543 U.S. 426, *Doc 2005-1418*, *2005 TNT 15-10* (2005). *See* Robert W. Wood, ''Supreme Court Attorney Fees Decision Leaves Much Unresolved,'' *Tax Notes*, Feb. 14, 2005, p. 792, *Doc 2005-2351*, *2005 TNT 24-67*.

[3]*See Alexander v. Commissioner*, 72 F.3d 938, *Doc 96-602*, *96 TNT 1-74* (1st Cir. 1995); *Raymond v. United States*, 355 F.3d 107, *Doc 2004-760*, *2004 TNT 10-11* (2d Cir. 2004), *petition for cert. filed*, 72 U.S.L.W. 1437 (U.S. Apr. 9, 2004) (No. 03-1415); *O'Brien v. Commissioner*, 38 T.C. 707 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963), *cert. denied,* 375 U.S. 930 (1963); *Young v. Commissioner*, 240 F.3d 369, *Doc 2001-1324*, *2001 TNT 9-24* (4th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3d 881, *Doc 2001-21203*, *2001 TNT 154-9* (7th Cir. 2001); *Bagley v. Commissioner*, 121 F.3d 393, *Doc 97-23056*, *97 TNT 152-5* (8th Cir. 1997), *en banc reh'g denied,* 1997 U.S. App. LEXIS 27256 (8th Cir. 1997); *Benci-Woodward v. Commissioner*, 219 F.3d 941, *Doc 2000-20007*, *2000 TNT 144-8* (9th Cir. 2000), *cert. denied,* 531 U.S. 1112 (2001); *Coady v. Commissioner*, 213 F.3d 1187, *Doc 2000-16766*, *2000 TNT 117-9* (9th Cir. 2000), *cert. denied,* 532 U.S. 972 (2001); *Sinyard v. Commissioner*, 268 F.3d 756, *Doc 2001-24862*, *2001 TNT 188-11* (9th Cir. 2001), *cert. denied*, 536 U.S. 904, (2002); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312, *Doc 2001-31455*, *2001 TNT 247-75* (10th Cir. 2001), *cert. denied,* 535 U.S. 1056 (2002); *Baylin v. Commissioner*, 43 F.3d 1451, *Doc 95-342*, *95 TNT 4-23* (Fed. Cir. 1995).

plaintiff, but only to the attorney.[4] That split created disparate and inequitable results in different circuits, primarily because of the alternative minimum tax. Despite the split, the Supreme Court declined certiorari in five cases before accepting it in *Banks* and *Banaitis*.[5] Those cases were consolidated before the Supreme Court.[6]

In *Banks* the Supreme Court held that contingent attorney fees generally represent income to the plaintiff. Unfortunately, *Banks* only partially answers the myriad questions concerning attorney fee taxation.[7] Although the Court announced that contingent attorney fees were income to the plaintiff, it expressly announced that only as a general rule, carving out several substantive issues it did not address.

For example, the Court did not address the appropriate tax treatment of attorney fees in cases involving injunctive relief or statutory fee shifting provisions. Since then, there has been little additional guidance from the courts and none from the IRS.[8] One area in which *Banks* was conspicuously silent concerns class-action attorney fees. In some ways, that makes sense, because neither of the underlying cases were class actions.

But given that the Court had previously denied certiorari in a case involving attorney fees paid in a class action, it could not have been unaware of this issue.[9] Moreover, the Court did not consider the effect of cases in which injunctive relief is sought by the plaintiff, thus raising the specter of an allocation of attorney fees between the fees expended in pursuing injunctive relief and those expended in pursuing money damages. That often occurs in a class action.

Even without guidance in *Banks*, the tax treatment of class-action attorney fees is not without direction. Although the tax treatment of class-action attorney fees has some complexity, the most important factor is whether a case is an opt-out or an opt-in variety. This article focuses solely on the opt-out class action.

Attorney Fees and Boeing History

In a recent article, I discussed Boeing's $615 million settlement with the federal government.[10] That largest-ever settlement paid by a defense contractor came after years of federal investigation, public scandal, resignations of company officers, and even jail time for some of the players. Perhaps the most interesting aspect of this settlement was caused by Boeing's postsettlement statements that suggested it could deduct the settlement payment. According to Boeing, section 162(f), which prohibits the deduction of fines and penalties, should not affect its ability to claim a deduction.

In times of budget deficits, such brazen commentary caught the attention of some members of Congress. They immediately chastised the Justice Department, wondering how the government had been hoodwinked to the tune of hundreds of millions of dollars. Political pressure soon mounted, mostly due to some public carping by Senate Finance Committee ranking minority member Max Baucus, D-Mont., and Sen. John McCain, R-Ariz. Boeing informally (but publicly) relinquished any thought of claiming a deduction.[11]

But Boeing's recent settlement is not its first 15 seconds of tax fame. That came nearly 30 years ago, and is worth revisiting given the subject of this article. Boeing's big foray into class-action history is a fine canvas on which to paint current class-action rules.

Early Flight History

Boeing's class-action attorney fees story started 40 years ago in 1966, when the company called for the redemption of some convertible bonds. The redemption allowed bondholders, for each $100 bond, to receive $103.25 or two shares of common stock, which at that time was worth $316.25. That's a whopping difference. The call feature of the bonds (as determined concurrently with their issuance) provided that bondholders who failed to choose an alternative would receive only cash.

To alert investors, Boeing mailed notices to registered owners and placed notices in newspapers. Boeing gave the bondholders less than a month to formally elect stock or cash. Bondholders who missed the deadline received cash. Given the financial disparity between the alternatives, it didn't take a Boeing rocket scientist to realize that bondholders who missed the deadline got a raw deal.

Shortly after the deadline, several bondholders who missed the deadline filed a class action against Boeing, alleging violations of federal and state securities laws

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[4]*See Cotnam v. Commissioner,* 263 F.2d 119 (5th Cir. 1959); *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Davis v. Commissioner*, 210 F.3d 1346, *Doc 2000-12246*, *2000 TNT 86-7* (11th Cir. 2000); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000); *Banaitis v. Commissioner*, 340 F.3d 1074, *Doc 2003-19359*, *2003 TNT 167-5* (9th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2385 (U.S. Mar. 29, 2004) (No. 03-907); *Banks v. Commissioner*, 345 F.3d 373, *Doc 2003-21492*, *2003 TNT 190-11* (6th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2384 (U.S. Mar. 29, 2004) (No. 03-892).

[5]The Supreme Court denied certiorari on this attorney fees issue five times before *Banks*. *See O'Brien v. Commissioner*, 319 F.2d 532 (3d Cir. 1963), *cert. denied*, 375 U.S. 930 (1963); *Benci-Woodward v. Commissioner*, 219 F.3d 941, *Doc 2000-20007*, *2000 TNT 144-8* (9th Cir. 2000), *cert. denied,* 531 U.S. 1112 (2001); *Coady v. Commissioner*, 213 F.3d 1187, *Doc 2000-16766*, *2000 TNT 117-9* (9th Cir. 2000), *cert. denied,* 532 U.S. 972 (2001); *Sinyard v. Commissioner*, 268 F.3d 756, *Doc 2001-24862*, *2001 TNT 188-11* (9th Cir. 2001), *cert. denied*, 536 U.S. 904, (2002); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312, *Doc 2001-31455*, *2001 TNT 247-75* (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002).

[6]*Banaitis v. Commissioner*, 340 F.3d 1074, *Doc 2003-19359*, *2003 TNT 167-5* (9th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2385 (U.S. Mar. 29, 2004) (No. 03-907); *Banks v. Commissioner*, 345 F.3d 373, *Doc 2003-21492*, *2003 TNT 190-11* (6th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2384 (U.S. Mar. 29, 2004) (No. 03-892).

[7]*See* Wood, *supra* note 2.

[8]*See* Wood, "Contingent Attorney Fees in the Post-*Banks* Era," *Tax Notes*, Feb. 6, 2006, p. 663, *Doc 2006-1793*, *2006 TNT 25-77*.

[9]*See Sinyard v. Commissioner*, 268 F.3d 756, *Doc 2001-24862*, *2001 TNT 188-11* (9th Cir. 2001), *cert. denied*, 536 U.S. 904 (2002).

[10]*See* Robert W. Wood, "'It's Deductible': Sharp Pencils and Boeing's Imbroglio," *Tax Notes*, Sept. 18, 2006, p. 1053, *Doc 2006-15626*, *2006 TNT 181-37*.

[11]*Id*.

based on lack of reasonable notice. They sought damages for the value lost by not being able to convert their bonds into stock. The lawsuit was an opt-out class action, so all former bondholders who failed to convert their bonds to stock were automatically considered part of the plaintiff class, with no need to affirmatively join the class.

Of course, a class member could elect out of the class (if he wanted to pursue separate litigation or was content with the cash). The plaintiff class eventually won damages from Boeing, but it was a long, drawn-out battle. Even though the class was victorious, not all class members claimed their share. Indeed, during the decade of litigation, class counsel was unable to locate many class members. That is interesting because the class contained a finite number of members. As we'll see below, after Boeing conceded defeat on quantum, it continued to fight over what to do with the unclaimed recovery attributable to the unidentified former bondholders.

The Trials

Ironically, the tale begins with the trial court dismissing the action on the grounds that adequate notice *had* been given. The Second Circuit reversed and remanded, finding the notice inadequate.[12] On remand, the district court ruled in favor of the class, awarding damages equal to the difference between the stock and cash values.[13] However, the court refused to assess prejudgment interest. Given that several years had passed by then, that interest amount was substantial.

The plaintiffs again appealed, claiming that the trial court improperly denied prejudgment interest. They also claimed that the damages allocated to unknown bondholders (and thus not claimed by anyone) should be divided among known bondholders. After all, a class-action award is typically made to the class, not to particular class members. In the alternative, they argued that if they were not entitled to share in the unclaimed damages, they should at least be able to use the unclaimed damages to help pay their contingent legal fees.

Although the Second Circuit awarded prejudgment interest to the class, it also ruled that the identified class members could not share in the unclaimed recovery.[14] Allowing those class members to share this amount, it reasoned, would create a ''fluid class'' recovery, a rationale rejected in *Eisen v. Carlisle & Jacquelin*.[15] Such a recovery would expropriate funds belonging to class members who had not asserted their claims and would give a windfall to others who had. That rationale was apparently based on the fact that the plaintiff class was finite, even though all of its members had not been identified.

Next, the Second Circuit concluded that because the claiming class members could not directly benefit from the unclaimed portion of the award, they could not indirectly benefit by using the unclaimed award to pay their attorney fees. Throughout the litigation, Boeing had argued that it had a right of reversion to the unclaimed award. The court thought that allowing the unclaimed award to defray the attorney fees of those who claimed their award might be tantamount to shifting fees to the losing party in violation of the American rule.[16] Unlike the English litigation rule, in which the loser generally pays the winner's attorney fees, American courts generally let each side bear its own fees.

Ultimately, the Second Circuit remanded the case for the second time. On the second remand, the district court established the total amount of Boeing's liability to the class as a whole. Since the court knew how many bonds existed, it fixed the amount each class member could recover. That was atypical of class actions. Thereafter, the court concluded that each class member's recovery included a proportionate share of class expenses, including attorney fees.

By that point, the parties were close to accepting the courts' rulings. Boeing had (finally) come to terms with the fact that it had lost, and it only appealed the third district court ruling concerning one issue: whether a proportionate share of the attorney fees could be assessed against the unclaimed portion of the fund created by the judgment. It argued that the equitable common fund doctrine, which allows the assessment of attorney fees against a common fund created by the lawyer's efforts, was inapposite since the money in the fund would not benefit class members who failed to claim it.

Moreover, Boeing continued to argue that it had a right to have the unclaimed funds returned because to do otherwise would fly in the face of the American rule against shifting fees to the losing party. Initially, the Second Circuit agreed with Boeing.[17] But shortly thereafter, the Second Circuit, sitting *en banc*, affirmed the district court's judgment.[18] The full appeals court found that each member of the class had a ''present vested interest'' in the class recovery and could collect his share of the recovery on request.

Thus, absentee class members had received a benefit within the meaning of the common fund doctrine. The court found that consonant with the American rule. Attorney fees would be paid only from the amount for which Boeing had already been held liable. In other words, Boeing would not be paying the class members' attorney fees.

Given the tortured Ping-Pong ball this case had already become, it is hardly surprising that Boeing sought review by the Supreme Court. Although the Supreme Court had denied certiorari once before, it now granted it. Ultimately, the Court agreed with the Second Circuit sitting *en banc* and ruled against Boeing. In the process, it elucidated the common fund doctrine.

[12] *Van Germert v. Boeing*, 520 F.2d 1373 (2d Cir. 1977), *cert. denied*, 423 U.S. 947 (1975).

[13] *Van Germert v. Boeing*, 1976 U.S. Dist. LEXIS 12401 (S.D.N.Y. 1976).

[14] *Van Germert v. Boeing*, 553 F.2d 812 (2d Cir. 1977).

[15] 479 F.2d 1005 (2d Cir. 1973), *vacated and remanded on other grounds*, 417 U.S. 156 (1974).

[16] 553 F.2d 812, *referencing Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U.S. 240 (1975).

[17] 573 F.2d 733 (1978).

[18] 590 F.2d 433 (1978).

Common Fund

Much of the opt-out class-action attorney fee case law concerns whether counsel will be paid from a so-called common fund. The common fund doctrine has a long history and reflects traditional practice in courts of equity. In a more halcyon era, courts were divided into law and equity, the latter being more flexible in rules and remedies. The evolution of the common fund can be traced to the 19th century, when the Supreme Court recognized that a litigant (or a lawyer) who recovers a common fund for the benefit of persons other than himself (or his client) is entitled to a reasonable attorney fee from the fund as a whole.[19]

This doctrine stands as a recognized exception to the general principle that every litigant must bear his own attorney fees (that is, the American rule).[20] The common fund lore rests on the principle that persons who obtain the benefit of a successful lawsuit without contributing to its cost are unjustly enriched at the successful litigant's expense.[21] Thus, courts typically retain jurisdiction over a fund produced by the litigation, effectively preventing inequity by assessing attorney fees against the entire fund. That assessment spreads fees proportionately among those benefited by the suit.[22] That's the idea anyway.

The Supreme Court in *Boeing* lays out three features that distinguish a common fund case from one in which the shifting of fees is inappropriate. First, the classes of persons benefited by the lawsuit must be "small in number and easily identifiable." Second, the "benefits could be traced with some accuracy." Third, "there [should be] reason for confidence that the costs [of litigation] could indeed be shifted with some exactitude to those benefitting."[23]

According to the Court, those three characteristics are not present when litigants simply vindicate a general social grievance. However, the triumvirate of criteria is satisfied when each class member has an "undisputed and mathematically ascertainable claim to part of a lump-sum judgment recovered on his behalf."[24] Thus, in a common fund case, once the defendant's liability has been established and the total amount of damages is known, members of the class can obtain their share of the recovery simply by proving their individual claims against the fund.

All of the identifiable persons whom the court has certified as class members can obtain benefits with certainty. Of course, the full value of the benefit to each absentee member may not be determined until he presents his claim. Nonetheless, attorney fees awarded against the entire fund will shift the costs of litigation to each absentee.

Turning back to the facts of *Boeing*, the Court found that the class representative recovered a sum certain for the benefit of every class member. Boeing did not appeal the judgment awarding that definite amount, nor did it contend that any class member was not injured by its failure to adequately inform him of his conversion rights. The damage to each class member was simply the difference between the redemption price of his debentures and the value of the common stock into which the debentures could have been converted.

Absentee class members needed only to prove class membership to claim their share of the award. According to the Court:

> Their right to share the harvest of the lawsuit upon proof of their identity, whether or not they exercise it, is a benefit in the fund created by the efforts of the class representatives and their counsel. Unless absentees contribute to the payment of attorney's fees incurred on their behalves, they will pay nothing for the creation of the fund and their representatives may bear additional costs.[25]

The Court noted that the decision of the trial court (affirmed by the court of appeals) effectively prevents inequity by requiring every member of the class to share attorney fees to the same extent that he shares the recovery. Because the benefits of the class recovery had been "traced with some accuracy" and the costs of recovery had been "shifted with some exactitude to those benefitting," the Court concluded that the attorney fee award was a proper application of the common fund doctrine.[26]

Further, the Court concluded that the common fund doctrine was consistent with the American rule, preventing the losing party from paying the victor's attorney fees.[27] The trial court assessed attorney fees against a fund awarded to the class as a whole. Boeing did not appeal the judgment quantifying its liability, so it had no interest in any part of the fund. In other words, the class members (whether or not they asserted their rights) were the equitable owners of their respective shares in the recovery.

Modern View

It may be satisfying to understand some of the history and fundamentals of the common fund doctrine, but many practitioners — litigators and tax professionals alike — may want to know only what all of this means today in the context of class-action attorney fees. The latter supposition may be especially true, since the IRS rarely cites *Boeing*. Nonetheless, the concepts espoused by the Supreme Court in *Boeing* serve as the foundation for much of the IRS's current position on class-action attorney fees. That makes *Boeing* of more continuing relevance than you might think.

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[19] *See Trustees v. Greenough*, 105 U.S. 527 (1882). *See also Central Railroad & Banking Co. v. Pettus*, 113 U.S. 116 (1885); *Sprague v. Ticonic National Bank*, 307 U.S. 161 (1939); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970); *Hall v. Cole*, 412 U.S. 1 (1973).

[20] *Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U.S., at 257-258.

[21] *See, e.g., Mills v. Electric Auto-Lite Co.*, 396 U.S. at 392.

[22] *See id*. at 394.

[23] *See Boeing*, 444 U.S. at 478, *quoting Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U.S. 240, 265, n.39 (1975).

[24] *Boeing,* 444 U.S. at 479.

[25] *Id.* at 480.

[26] *Id.*

[27] *Id.* at 481.

Although the IRS relies on *Boeing*, it begins virtually every case, ruling, and memo with general platitudes about section 61. That section provides that except as otherwise provided by law, gross income includes all income from whatever source derived. The regulations under section 61 also provide that gross income includes income realized in any form.[28] The Supreme Court has practically galvanized the subject, stating that the concept of gross income encompasses accessions to wealth, clearly realized, over which taxpayers have complete dominion.[29] There may be recent chinks in that ''all income'' armor, notably *Murphy v. Commissioner*,[30] but the armor still seems pretty thick.[31]

The Supreme Court in *Banks* clarified the concept of gross income in the context of attorney fees. The Court held that a taxpayer must generally include in gross income the portion of taxable damages paid to his attorney as attorney fees even if the defendant makes payment directly to the taxpayer's attorney.[32] However, *Banks* expressly noted that it was only setting forth a general rule. The Court implied that there would be situations in which taxable damages would not be includable in a claimant's gross income.

Unfortunately, the Court did not make a complete list of exceptions. In fact, the Court hinted only at exceptions, suggesting that the general rule should not apply to cases in which an injunction is sought[33] or in which statutory fees are available. Even with that dearth of guidance, the general rule set forth in *Banks* should not apply to attorney fees paid to class counsel in an opt-out class action.

Opt-Out vs. Opt-In

A class action can be either opt-out or opt-in, and the tax consequences to class members can be different. In an opt-out case, no class member (other than the class representative) will generally execute a fee agreement with class counsel, and potential class members 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 class as defined.

Thus, unlike the situation prevailing in *Boeing*, in the typical opt-out class action, the precise composition of the class is not known and class counsel often will reserve a portion of the fund for class members who may be identified at a later date. For example, a class representative might sue his former employer on behalf of all similarly situated employees who held positions at the 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.

Nonetheless, in an opt-out lawsuit, a class member has the right and power to affirmatively exclude himself from the class before the date set by the court for payment.[34] The characteristics of an opt-out class action are in sharp contrast with those of an opt-in class 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.[35]

The most important federal income tax distinction between those two types of class actions concerns the inclusion of attorney fees. Historically, the IRS has often not bothered with attorney fees in the class-action context. I wish I could say there is never extra income to class members based on attorney fees. Unfortunately, that's not so. However, it is normal to worry about this issue only in opt-in cases, for which the connections between class counsel and clients are stronger.

Although it may not be fair — and there may be ways to ameliorate or avoid this result — it is easier to see that in an opt-in class action, each class member may have gross income in the amount of his proportionate share of attorney fees. That tax rule is grounded in each class member's contractual agreement to pay legal fees.[36] Some have suggested that this gross income inclusion is based on a defendant's knowledge of the identity of the class members. After all, the defendant may know the identity of all members in an opt-in class action. However, the Ninth Circuit in *Sinyard v. Commissioner* plainly states that the rationale for the inclusion of attorney fees in an opt-in class action is based *solely* on a contractual obligation theory.[37]

In an opt-out class action, however, class members are typically not required to include their share of attorney fees in their respective gross incomes. The theory for excluding attorney fees is that ''as of the time fees are awarded, not all members of a class have become identified or contractually obligated to compensate'' class counsel.[38] Oddly enough, the seminal case on this point is the district court decision in *Eirhart v. Libbey-Owens-Ford Co.*[39]

In most class actions, both tests set forth in *Eirhart* will have been met. That is, not all class members will have

[28]Reg. section 1.61-1(a).

[29]*Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). Note, however, that the definition of gross income may have been modified by the recent discussion of the D.C. Circuit in *Murphy v. IRS*, No. 05-5139, *Doc 2006-15916*, *2006 TNT 163-6* (D.C. Cir. Aug. 22, 2006), *petition for rehearing denied* (Oct. 31, 2006).

[30]*Id.*

[31]There is much debate about this decision, and it is well beyond the scope of this article. *See* Sheryl Stratton, ''Experts Ponder *Murphy* Decision's Many Flaws,'' *Tax Notes*, Sept. 4, 2006, p. 822, *Doc 2006-18393*, *2006 TNT 171-3*.

[32]*See Commissioner v. Banks*, 543 U.S. 426, *Doc 2005-1418*, *2005 TNT 15-10* (2005). *See also Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929).

[33]Unfortunately, it is not clear if this means the injunction is the major part of the case, the only part of the case, and so on.

[34]*See Eirhart v. Libbey-Owens-Ford Company*, 726 F. Supp. 700 (N.D. Ill. 1989).

[35]*See Sinyard v. Commissioner*, T.C. Memo. 1998-364, *aff'd*, 268 F.3d 756, *Doc 2001-24862*, *2001 TNT 188-11* (9th Cir. 2001).

[36]*Id.* at 758.

[37]*Id.*

[38]*Sinyard*, T.C. Memo. 1998-364 at 15, *discussing Eirhart v. Libbey-Owens-Ford Co.*, 726 F. Supp. 700 (N.D. Ill. 1989).

[39]726 F. Supp. 700 (N.D. Ill. 1989).

been identified, and not all class members will be contractually obligated to compensate class counsel. 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 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 what seem to be *alternative* tests set forth in *Eirhart*, the IRS 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. Over the past few years, the IRS has issued numerous private letter rulings on this topic. In those rulings, the IRS has consistently ruled that payments made to class counsel in an opt-out class action are not income to the class members.[40]

Of course, private letter rulings are requested by a particular taxpayer concerning a specific situation. They cannot be used or cited as precedent and are directed only to the taxpayer requesting the ruling. However, they provide evidence of IRS beliefs and positions on the particular topic of the ruling.

In all of the above-cited opt-out class-action rulings, the IRS relies on Rev. Rul. 80-364[41] (Situation 3) as support for the proposition that attorney fees do not represent gross income to class members. In that ruling, a union filed claims on behalf of its members against a company because of the breach of a collective bargaining agreement. As part of a settlement, the company paid the union $40x. The union paid $6x for attorney fees and returned $34x to the employees for back pay.

The ruling concluded that the portion of the settlement paid by the union for attorney fees was a reimbursement of expenses incurred by the union and was not includable in the gross income of union members. Implicit in the ruling was the fact that the union knew the identities of its members. However, identity was not a factor in the IRS's analysis. To the mutual exclusion of identity, the IRS focused solely on the fact that class members in an opt-out class action have no contractual relationship with class counsel.[42]

In addition to private letter rulings, in Chief Counsel Advice 200246015,[43] IRS Chief Counsel set forth its own general principles for payments to class counsel:

> 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.[44]

Even though the IRS has issued many rulings in this area, the IRS's own rulings demonstrate that the IRS does not believe the Supreme Court's decision in *Banks* has changed the law on this point. The IRS has issued four rulings on this topic since *Banks* was decided.[45] In all four rulings, the IRS ruled that attorney fees paid to class counsel in an opt-out class action were not income to class members. In other words, the IRS clearly believes the general rule of *Banks* does not apply.

In all four rulings, the lack of a contract between the class members and the class counsel was critical. Similarly, LTR 200340004,[46] dealt with an opt-out class action alleging unlawful compensation practices. Before 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 acquired the authority to award attorney fees.

Under the equitable common fund doctrine, the court awarded attorney fees in the amount of 20 percent 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 those facts, the IRS ruled that the payments made to class counsel were not gross income to class members.

All of the recent private letter rulings dealing with the settlement of class-action lawsuits cite *Sinyard v. Commissioner*[47] and *Frederickson v. Commissioner*.[48] However, both cases are mentioned in the rulings in a ''but see'' context, suggesting that the rules provided by each case are not completely on point. For example, although *Sinyard* involved a class action, it was an opt-in class action. There, the court held that attorney fees paid to class counsel constituted gross income to Sinyard because he had entered into a contingency fee agreement with class counsel. That suggests that a class member who is not a class representative *could* have gross income in an opt-out class action if he signs a fee agreement with class counsel.

Frederickson, which also involved a class action, echoes *Sinyard*. The *Frederickson* decision does not expressly note whether the action there was an opt-in or opt-out case.

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[40]*See* LTRs 200518017, *Doc 2005-9587*, *2005 TNT 88-22*; 200344022, *Doc 2003-23552*, *2003 TNT 212-15*; 200340004, *Doc 2003-21684*, *2003 TNT 193-28*; 200316040, *Doc 2003-9910*, *2003 TNT 76-57*; 200222001, *Doc 2002-13011*, *2002 TNT 106-58*; 200106021, *Doc 2001-4001*, *2001 TNT 29-46*; 200025023, *Doc 2000-17353*, *2000 TNT 123-42*. *See also* 1994 FSA LEXIS 822.

[41]1980-2 C.B. 294.

[42]*See also* LTRs 200551008, *Doc 2005-25818*, *2005 TNT 247-16*; 200518107, *supra* note 40.

[43]A chief counsel advice (CCA) is a legal memorandum from the IRS Chief Counsel's Office.

[44]The CCA provides the following cites with regard to this quote: *Sinyard v. Commissioner,* T.C. Memo. 1998-364, *aff'd*, 268 F.3d 756, *Doc 2001-24862*, *2001 TNT 188-11* (9th Cir. 2001), *Frederickson v. Commissioner,* T.C. Memo. 1997-125, *Doc 97-6985*, *97 TNT 48-10*, *aff'd in unpub. opinion*, 166 F.3d 342, *Doc 1999-2027*, *1999 TNT 12-20* (9th Cir. 1998), and Rev. Rul. 80-364 (Situation 3), 1980-2 C.B. 294.

[45]LTRs 200625031, *Doc 2006-12251*, *2006 TNT 127-25*; 200610003, *Doc 2006-4663*, *2006 TNT 48-32*; 200609014, *Doc 2006-4154*, *2006 TNT 43-35*; 200551008, *Doc 2005-25818*, *2005 TNT 247-16*.

[46]*Doc 2003-21684*, *2003 TNT 193-28*,

[47]T.C. Memo. 1998-364, *aff'd*, 268 F.3d 756, *Doc 2001-24862*, *2001 TNT 188-11* (9th Cir. 2001).

[48]T.C. Memo. 1997-125, *aff'd in unpub. opinion,* 166 F.3d 342 (9th Cir. 1998).

However, Frederickson personally entered into the settlement agreement to compensate class counsel. Presumably because of that, the court held that Frederickson had gross income in the amount of the attorney fees paid to class counsel. Implicit in the decision is the notion that Frederickson had agreed to pay legal fees and that his debt for those fees would be discharged if instead the defendant paid them.

Although not stated in the decision, *Frederickson* is probably based on the rationale of the Supreme Court decision in *Old Colony Trust Co. v. Commissioner*.[49] That case held that when a payment is made to satisfy the obligation of a taxpayer to a third party, the payment is generally includable in the taxpayer's gross income. Even though the taxpayer never actually receives that payment, the taxpayer receives its benefit and therefore has gross income.

Under that rationale, Frederickson had gross income. This rationale, however, is usually not applicable to an opt-out class action. Although class members may receive a benefit from the litigation, there is generally no express contractual liability between class members and class counsel, so there's no income.

Reporting

A discussion of gross income and attorney fees would be incomplete without some mention of the reporting requirements for those payments. Indeed, reporting issues often start the debate on this topic, with plaintiffs' counsel asking defendants to ensure that attorney fees are not reported to the class and defendants trying to figure out how to respond. It should be no surprise that this happens. An unruly class can become decidedly more unruly if class members end up with a check for $100 each and a Form 1099 showing that each received $150.

Sometimes the disparity between cash and tax can be horrible. The debates can be tough in opt-in cases. In opt-out cases, however, they should not be.

As a general rule, section 6041 requires all persons engaged in a trade or business and making payments of $600 or more in any tax year to file an information return with the IRS and with the payee. The regulations provide that payments are fixed when they are paid in amounts definitely predetermined.[50] Income is determinable when there is a basis of calculation by which the amount to be paid may be ascertained. The regulations require a payer to report section 6041 amounts on Form 1099.[51]

Aside from those basics, the question is whether defendants or law firms as payers need to issue Forms 1099 to clients for the legal fees. As discussed above, attorney fees typically should not be includable in the gross income of class members in an opt-out case. Consequently, the payments of attorney fees to class counsel should not be reportable to class members on Form 1099 under section 6041.[52] That conclusion conforms to the many letter rulings.[53] In each such private letter ruling, payments to class counsel for attorney fees were determined not to constitute gross income to class members. Those rulings also state that the attorney fees were not subject to the reporting requirements of section 6041 with respect to class members.

Conclusion

Despite the lack of a unified vision of the tax treatment of attorney fees, the taxation of attorney fees in opt-out class actions has become relatively certain as long as specific elements are established. The rules have not always been so clear, and the equitable common fund doctrine was developed over many years by numerous cases. Even though the equitable common fund doctrine is often not mentioned by name, its values and results permeate opt-out class-action jurisprudence.

Most importantly, the IRS has tacitly incorporated it into its rulings. Perhaps there is a risk of oversimplification. But put simply, in opt-in cases, the class members are at risk of being tagged with income in the amount of the attorney fees. In opt-out cases, they are not. That means opt-out cases generally don't involve tax problems provoked by the attorney fees, and all the attention, energy, and worry should focus on opt-in cases.

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[49] 279 U.S. 716 (1929).

[50] Reg. section 1.6041-1(c).

[51] Reg. section 1.6041-1(a)(2).

[52] *See Eirhart*, 726 F. Supp. 700 at 706.

[53] *See* LTRs 200625031, *supra* note 45; 200610003, *supra* note 45; 200518017, *supra* note 40; 200344022, *supra* note 40; 200340004, *supra* note 40; 200316040, *supra* note 40; 200222001, *supra* note 40; 200106021, *supra* note 40; 200025023, *supra* note 40.