Confusion on Tax Treatment of Class Action Attorney Fees

By Robert W. Wood

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In *Commissioner v. Banks*,[1] the Supreme Court held that contingent attorney fees generally represent income to the plaintiff. The Court did carve out several substantive issues that it did not address. For example, the Court did not rule on the tax treatment of attorney fees in cases involving injunctive relief or statutory fee-shifting provisions. More importantly, however, *Banks* was silent on class action attorney fees because neither of the tax cases considered there arose out of class actions.

The big tax question is whether amounts paid to class counsel are income to class members. It's an issue of considerable magnitude. If a plaintiff nets $1,000 in a case, but is treated as receiving $2,000 attributable to his pro rata share of attorney fees, he will certainly care. Paying tax on money you didn't receive is never pleasant.

If attorney fees represent income to the plaintiffs, deducting them may not be easy. In 2004 Congress eked out a partial reform concerning the deductibility of attorney fees in employment and other cases.[2] Yet, outside the employment litigation arena, if a plaintiff is attributed income measured by the amount of attorney fees his counsel receives, there is often no decent way to deduct them. In effect, the plaintiff pays tax on money he never sees. 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.

Before *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.[3] The minority circuits had held the fees were not income to the plaintiff, only to the attorney.[4] This created disparate results in different circuits, with some plaintiffs escaping tax on the attorney fees, and some paying it.

Banks made it worse. 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 now provided by section 62, but only in employment cases and federal False Claims Act cases;
- a trade or business expense (perhaps on a 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 percent 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 great number of unhappy plaintiff-taxpayers every year.

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

[2] *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, *Doc 2004-21482*, *2004 TNT 215-27*.

[3] *See Alexander v. Commissioner*, 72 F.3d 938 (1st Cir. 1995); *Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004), *Doc 2004-16921*, *2004 TNT 163-14*, *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 (4th Cir. 2001), *Doc 2001-1324*, *2001 TNT 9-24*; *Kenseth v. Commissioner*, 259 F.3d 881 (7th Cir. 2001), *Doc 2001-21203*, *2001 TNT 154-9*; *Bagley v. Commissioner*, 121 F.3d 393 (8th Cir. 1997), *Doc 97-23056*, *97 TNT 152-5*, *en banc reh'g denied* 1997 U.S. App. LEXIS 27256 (8th Cir. 1997); *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000), *Doc 2000-20007*, *2000 TNT 144-8*, *cert. denied*, 531 U.S. 1112 (2001); *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000) *Doc 2000-16766*, *2000 TNT 117-9*, *cert. denied*, 532 U.S. 972 (2001); *Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir. 2001), *Doc 2001-24862*, *2001 TNT 188-11*, *cert. denied*, 536 U.S. 904, (2002); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312 (10th Cir. 2001), *Doc 2001-31455*, *2001 TNT 247-75*, *cert. denied*, 535 U.S. 1056 (2002); *Baylin v. Commissioner*, 43 F.3d 1451 (Fed. Cir. 1995), *Doc 95-342*, *95 TNT 4-23*.

[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 (11th Cir. 2000), *Doc 2000-12246*, *2000 TNT 86-7*; *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000), *Doc 2000-20090*, *2000 TNT 145-9*; *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003), *Doc 2003-19359*, *2003 TNT 167-5*, *petition for cert. granted*, 2004 U.S. LEXIS 2385 (U.S. Mar. 29, 2004) (No. 03-907); *Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003), *Doc 2003-21492*, *2003 TNT 190-11*, *petition for cert. granted*, 2004 U.S. LEXIS 2384 (U.S. Mar. 29, 2004) (No. 03-892).

Common Fund Theory

To address attorney fees in class actions, it is important to start with a little history and some nomenclature. Much of the class action attorney fees law revolves around 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 a more halcyon era, courts were divided into courts of law and equity, the latter being more flexible in both rules and remedies. The evolution of the common fund in this country can be traced to the 19th century, in which 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.[5]

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).[6] This American rule contrasts with the British rule, under which losers in litigation generally must pay for 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.[7]

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.[8] The Supreme Court laid out three features that distinguish a common fund case.[9]

First, the classes of persons benefited by the lawsuit must be small in number and easily identifiable. Second, the benefits must be capable of being 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.[10] According to the Court, those three characteristics are not present when litigants simply vindicate a general social grievance. However, they are satisfied when each class member has an "undisputed and mathematically ascertainable claim to part of a lump-sum judgment recovered on his behalf."[11]

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 by proving their individual claims against the fund. In *Boeing Co. v. Van Gemert*,[12] the class representative recovered a sum certain (related to a stock conversion right) for the benefit of every class member.

Absentee class members merely needed 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.[13]

According to the Supreme Court in *Boeing*, requiring every member of the class to share attorney fees (to the same extent as he shares the recovery) prevents inequity. As we'll see, this rule ties into tax treatment.

Modern View

Many practitioners — both litigators and tax professionals — care little about common fund theory. They only want to know who pays tax on class action attorney fees. The Supreme Court in *Banks* clarified that a taxpayer must "generally" include in gross income the portion of taxable damages paid to his attorney as attorney fees. This is so even if the defendant makes payment directly to the taxpayer's attorney.[14] However, *Banks* implied that there would be situations in which attorney fees would not be includable 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 an injunction is sought,[15] or in which statutory fees are available. Although fees in class actions are not discussed, it is possible to discern some clear guidelines from other tax authorities.

Opt-Out vs. Opt-In Cases

A class action can be either an opt-out or opt-in case, and 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 don't need to take 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

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[5] *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).

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

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

[8] *See id.*, at 394.

[9] *See Boeing Co. v. Van Gemert*, 444 U.S. 472 (1980).

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

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

[12] 444 U.S. 472 (1980).

[13] *Boeing*, at 480.

[14] *See Commissioner v. Banks*, 543 U.S. 426 (2005). *See also Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929).

[15] Unfortunately, it is not clear if this means the injunction is the *major* part of the case, the *only* part of the case, etc.

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 power to affirmatively *exclude* himself from the class before a date set by the court.[16] 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.[17]

This opt-in versus opt-out character affects more than just tax issues, but the tax consequences are huge. The most important federal income tax distinction between those two types of class actions concerns the inclusion of attorney fees. It is usually possible to worry about this tax issue only in opt-in cases, when the connections between class counsel and clients are stronger. In an opt-in class action, each class member may have gross income in the amount of his proportionate share of attorney fees. This tax rule is grounded in each class member's contractual agreement to pay legal fees.[18]

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 v. Commissioner*[19] plainly states that the inclusion of attorney 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 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.[20] Oddly enough, the seminal case on this point is a district court decision, *Eirhart v. Libbey-Owens-Ford Co*,[21] which established a two-part test: whether or not all class members are identified, and whether 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' attorneys 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 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 IRS has consistently maintained 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 several private letter rulings, consistently ruling that payments made to class counsel in an opt-out class action are not income to the class members.[22] The IRS relies on Rev. Rul. 80-364[23] (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.[24]

Further, in CCA 200246015,[25] *Doc 2002-25565*, *2002 TNT 222-43*, 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.[26]

Post-*Banks* Rulings

Although the Supreme Court in *Banks* did not deal with class action attorney fees, there's been some comfort following the decision. 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 rulings on this topic since *Banks* was decided,[27] 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, 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

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

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

[18]*See Sinyard,* 268 F.3d at 758.

[19]*Id*.

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

[21]726 F. Supp. 700 (N.D. Ill. 1989).

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

[23]1980-2 C.B. 294.

[24]*See also* LTR 200551008, *Doc 2005-25818*, *2005 TNT 247-16*; LTR 200518017, *Doc 2005-9587*, *2005 TNT 88-22*.

[25]Chief counsel advice is a legal memorandum from the IRS Chief Counsel's Office.

[26]The chief counsel advice provides the following cites with regard to this quote: *Sinyard v. Commissioner,* T.C. Memo. 1998-364, *aff'd*, 268 F.3d 756 (9th Cir. 2001), *Frederickson v. Commissioner,* T.C. Memo. 1997-125, *aff'd in unpub. opinion*, 166 F.3d 342 (9th Cir. 1998), and Rev. Rul. 80-364 (Situation 3), 1980-2 C.B. 294.

[27]LTR 200625031, *Doc 2006-12251*, *2006 TNT 127-25*; LTR 200610003, *Doc 2006-4663*, *2006 TNT 48-32*; LTR 200609014, *Doc 2006-4154*, *2006 TNT 43-35*; LTR 200551008.

example, LTR 200340004, *Doc 2003-21684*, *2003 TNT 193-28*, 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 awarded attorney fees equal to 20 percent of the settlement. The court disregarded the contingency fee arrangement to which the attorneys would have been entitled if the action proceeded without class certification. Under those 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 v. Commissioner*[28] and *Frederickson v. Commissioner*[29] 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 attorney 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 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 opt-out action. However, Frederickson personally entered into the settlement agreement to compensate class counsel, so it is not surprising that the court held Frederickson had gross income on the attorney fees.

Reporting

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

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 a Form 1099 with the IRS.[30] 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.[31] Generally, however, if it is clear that the attorney fees are excludable 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 payers in a class action need to issue Forms 1099 to class members for the legal fees. 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 in an opt-out case should not be reportable to class members on Form 1099.[32]

This conclusion conforms to several private letter rulings,[33] in which 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 regarding 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. If you have an opt-in case, further thoughts and planning regarding these tax issues is usually required.

Conclusion

The taxation of attorney fees in opt-out class actions has become relatively certain, as long as particular elements are established. Even though the equitable common fund doctrine may not be mentioned by name, its values and results permeate opt-out class action cases. Notably, the IRS has tacitly incorporated it into its rulings.

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 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 focus on the tax issues present in opt-in cases.

Be careful out there!

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[28]T.C. Memo. 1998-364, *aff'd* 268 F.3d 756 (9th Cir. 2001).

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

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

[31]*See* section 6045F and accompanying regulations.

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

[33]*See* LTR 200625031; LTR 200610003; LTR 200518017; LTR 200344022; LTR 200340004; LTR 200316040; LTR 200222001; LTR 200106021; LTR 200025023.