

# Class Actions and the Attorneys' Fees Conundrum

**An upcoming Supreme Court decision on contingent attorneys' fees may affect the taxation of such fees awarded in class actions. This article examines the class action fees issue and how the courts and the IRS currently determine whether such fees should be included in class members' gross income.**

Due to a variety of oddities in the tax system (most notably, the alternative minimum tax (AMT)), there is a dramatic tax difference between a plaintiff being taxed on a settlement's gross amount, instead of an amount net of recovered attorneys' fees. In class actions, the IRS and the circuit courts have taken different approaches on the proper tax treatment of fee awards in "opt-in" and "opt-out" class action lawsuits. This article reviews the current law on contingent fee awards in general and in class actions in particular, analyzes whether class action attorneys' fees should be included in the plaintiffs' gross income and provides some recommendations.

## Background

It is no secret that the circuit courts do not agree on the tax treatment of contingent attorneys' fees recovered by plaintiffs. The majority has held that contingent attorneys' fees are gross income to the recover-

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ing plaintiff<sup>1</sup>; the minority has held that these fees do not constitute gross income to the recovering plaintiff.<sup>2</sup> Commentators have long noted the split in the circuits and the legislative efforts that have thus far failed to correct the problem.<sup>3</sup> Despite failing to reconcile these markedly different positions by denying *certiorari* on this issue on five prior occasions,<sup>4</sup> for reasons which are not yet clear, the Supreme Court recently agreed to consider the irreconcilable split in the circuits, by agreeing to review the Sixth Circuit's decision in *Banks*<sup>5</sup> and the Ninth Circuit's decision in *Banaitis*.<sup>6</sup> A petition for *certiorari* has also recently been filed from the Second Circuit's decision in *Raymond*.<sup>7</sup>

A significant difference in an individual's plaintiff's tax can result, depending on the treatment of fees.

**Example 1:** K, married and filing jointly, recovers a \$1 million nonbusiness settlement, inclusive of \$400,000 in attorneys' fees. Under the controlling circuit law, K is required to rec-

<sup>1</sup> See *Kenneth Alexander*, 72 F3d 938 (1st Cir. 1995); *David Raymond*, 355 F3d 107 (2d Cir. 2004), petition for cert. filed, S.Ct., 4/9/04; *Walter O'Brien*, 38 TC 707 (1962), aff'd, 319 F2d 532 (3d Cir. 1963), cert. den.; *Louise Young*, 240 F3d 369 (4th Cir. 2001); *Eldon Kenseth*, 259 F3d 881 (7th Cir. 2001); *Hughes Bagley*, 121 F3d 393 (8th Cir. 1997); *Ivor Benci-Woodward*, 219 F3d 941 (9th Cir. 2000), cert. den.; *Franklin Coady*, 213 F3d 1187 (9th Cir. 2000), cert. den.; *James T. Sinyard*, 268 F3d 756 (9th Cir. 2001), cert. den.; *Nancy Hukkanen-Campbell*, 274 F3d 1312 (10th Cir. 2001), cert. den.; *Jack Baylin*, 43 F3d 1451 (Fed. Cir. 1995).

<sup>2</sup> See *Ethel West Cotnam*, 263 F2d 119 (5th Cir. 1959); *Est. of Arthur Clarks*, 202 F3d 854 (6th Cir. 2000); *Willie Mae Davis*, 210 F3d 1346 (11th Cir.

2000); *Sudhir Srivastava*, 220 F3d 353 (5th Cir. 2000); *Sigita Banaitis*, 345 F3d 373 (9th Cir. 2003), cert. granted, S.Ct., 3/29/04; *John Banks II*, 345 F3d 373 (6th Cir. 2003), cert. granted, S.Ct., 3/29/04.

<sup>3</sup> See Wood, "More Confusion on Tax Treatment of Attorneys' Fees: Whose Law Applies?," 20 *BNA Emp. Discrim. Rep't* 701 (5/21/03); see also Wood and Flora, "Employment Lawyers Face Hidden Final IRS Rules on Forms 1099 for Attorneys," 19 *BNA Emp. Discrim. Rep't* 347 (9/25/02).

<sup>4</sup> See *O'Brien*, *Benci-Woodward*, *Coady*, *Sinyard* and *Hukkanen-Campbell*, note 1 supra.

<sup>5</sup> *Banks*, note 2 supra.

<sup>6</sup> *Banaitis*, note 2 supra.

<sup>7</sup> *Raymond*, note 1 supra.

ognize the gross amount. Thus, he is taxed on the entire \$1 million recovery and entitled to a miscellaneous itemized deduction, subject to the 2%-of-adjusted-gross-income (AGI) floor for the recovered legal fees. Thus, *K* owes \$276,500 in Federal income tax on the recovery. Of this amount, over \$75,000 stems from the AMT. In stark contrast, if *K* is only required to include the net amount of \$600,000 in gross income, he would owe a mere \$164,500 in Federal income tax—a staggering \$112,000 difference!

For cases arising out of a trade or business, a plaintiff would normally be able to deduct the entire amount of contingent attorneys' fees recovered. The Code does not expressly provide a deduction for such legal fees to obtain damages or settlement payments; however, such payments in connection with a trade or business are usually deductible business expenses under Sec. 162. To be deductible under Sec. 162, damages or settlement payments must be:

- Ordinary, necessary and reasonable expenses;
- Paid or incurred during the tax year for which a deduction is sought;
- Directly connected or proximately result from the taxpayer's trade or business;
- An expense rather than a capital expenditure;
- Not personal in nature;
- Paid by the person to whom such services are rendered; and
- Not contrary to public policy.

### Class Action Nuances

Do the same rules apply to class actions? Are the (often enormous) attorneys' fees paid to class counsel gross income to class members? Does it matter what kind of class action is involved? Is there a different result if the plaintiffs actually elect to join the class instead of merely failing to opt

out? Some of these questions are plaguing taxpayers; some are affecting lawyers. All of these questions should be a matter of concern for the IRS and the courts.

The taxation of contingent attorneys' fees in opt-in and opt-out class actions is discussed below. Historically, some commentators have argued that the Service has been somewhat lackadaisical in enforcement in this area. As will be seen, *Sinyard*<sup>8</sup> dispels any lingering misconceptions as to how the Service addresses this issue today.

### Opt-in Class Actions

An opt-in class action is a class action lawsuit that requires individuals to take affirmative action to be included in and bound by the resulting settlement or judgment. Class action lawsuits brought under the Fair Labor Standards Act of 1938 (FLSA), the Age Discrimination in Employment Act (ADEA) and the Equal Pay Act (EPA), require that potential plaintiffs opt-in if they wish to participate in the litigation and share in any recovery.

**Sinyard:** In *Sinyard*, the Ninth Circuit agreed with the Tax Court's determination that contingent attorneys' fees recovered by a plaintiff in an opt-in class action were includible in the plaintiff's gross income. The Service argued that attorneys' fees recovered in such class action, brought under the ADEA, resulted in gross income to the plaintiff.<sup>9</sup> The taxpayer asserted that because the class action defendant was liable to pay the attorneys' fees under court order, it had no gross income when the defendant actually paid its debt. The Ninth Circuit quoted *Old Colony Trust*,<sup>10</sup> stating, "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." The court went on to note that, under the ADEA, the prevailing plaintiff, not counsel, is entitled to attorneys' fees. The taxpayer had personally executed

<sup>8</sup> *James T. Sinyard*, TC Memo 1998-364, aff'd, 268 F3d 756 (9th Cir. 2001), cert. den.

<sup>9</sup> The IRS conceded that the plaintiff was entitled to a miscellaneous itemized deduction, subject

to the 2%-of-AGI floor and disallowance for AMT purposes.

<sup>10</sup> *Old Colony Trust Co.*, 279 US 716 (1929).

## EXECUTIVE SUMMARY

■ A plaintiff is subject to a significant (and arguably unfair) increase in tax when a fee award is included in gross income because, as a miscellaneous itemized deduction, it is subject to total disallowance for AMT purposes.

■ Fees awarded directly to the attorneys under the common fund theory are not includible in the members' gross income.

■ It is not yet clear the extent to which an upcoming Supreme Court decision on contingent fee awards will affect class actions.

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an agreement with class counsel, agreeing to pay for their services. Citing *Benci-Woodward*,<sup>11</sup> the court held the taxpayer to be in constructive receipt of the funds paid to class counsel; such amount was includible in gross income.

The Tax Court distinguished *Eirhart v. Libbey-Owens-Ford Co.*<sup>12</sup> from *Sinyard*, noting that *Eirhart* was based on a common fund theory that appears to apply only to opt-out class actions in which all class members have not yet been identified at the time the fees are awarded, and are not contractually obligated to compensate class counsel. The Tax Court reasoned that, for opt-out class actions, there may be policy reasons to treat recovered attorneys' fees as nontaxable to the class members (i.e., additional class members may later be identified and held responsible for a portion of the legal fees). Hence, it is not unreasonable to treat the funds recovered and used to pay attorneys' fees as nontaxable to the class members. In stark contrast, in an opt-in class action, such as one brought under the ADEA, all class members are identified when the class is closed—long before the settlement is finalized—and potential plaintiffs who failed to join the class are ineligible to share in any recovery.

**Payless Drug Stores cases:** A series of Tax Court cases involved former employees of Payless Drug Stores, Northwest, Inc. (Payless), who successfully asserted violations of the FLSA.<sup>13</sup> In a settlement with opt-in class members, Payless agreed to pay class members various amounts to settle their claims. The court held that attorneys' fees deducted from the settlement payments were includible in the class members' gross income. The Tax Court reasoned that, although the taxpayers did not physically receive the portion

of the settlement proceeds paid to the attorneys, they did receive benefits from those funds, in the form of payment for services required to obtain the settlement.<sup>14</sup> The taxpayers were permitted to deduct only the recovered fees as a miscellaneous itemized deduction, subject to the 2%-of-AGI floor and complete disallowance for AMT purposes.

**Kenseth:** The Tax Court held in *Kenseth*<sup>15</sup> that contingent attorneys' fees recovered by a plaintiff in an opt-in class action were includible in gross income, notwithstanding the fact that recovering class members had very little control over disbursement of the settlement funds. As the Tax Court noted, under the ADEA the prevailing plaintiff, not his or her counsel, is entitled to attorneys' fees. Moreover, Kenseth had personally executed a contingent fee agreement with class counsel, agreeing to pay for their services. The Tax Court found the taxpayer in constructive receipt of the funds paid to class counsel, and held the fees includible in gross income under the assignment-of-income doctrine (even though Kenseth had made an irrevocable assignment to his attorneys by executing the contingent fee agreement).

### Opt-out Class Actions

An opt-out class action is a class action lawsuit that does not require individuals to take affirmative action to be included in and bound by the resulting settlement or judgment. Potential plaintiffs in opt-out class actions whose needs will not be best served by the contemplated class action may opt-out. This will preserve any individual cause of action they might have against the defendant, and prevent them from being bound by any settlement or judgment.

**IRS guidance:** In a series of letter rulings,<sup>16</sup> the Service ruled that contingent attorneys' fees paid from qualified settlement funds, as defined by Sec. 468B and Regs. Sec. 1.468B-1(c), do not result in gross income to opt-out class members. Reasoning that the individual class members had not agreed to personally compensate class counsel, the Service held that attorneys' fees paid to plaintiffs' counsel were not includible in gross income.

The Service noted that this result was consistent with its holding in Situation 3 of Rev. Rul. 80-364,<sup>17</sup> in which a labor union, on behalf of its members, instituted an action against an employer for breaching a collective bargaining agreement. The union entered into a settlement agreement with the employer, under which the employer agreed to pay damages and attorneys' fees to the union. The union paid its counsel, and disbursed the remaining funds to its members. The Service held that the attorneys' fees were not includible in the union members' gross income; rather, it characterized the payment of attorneys' fees as a reimbursement for union expenses to enforce a collective bargaining agreement.

**State Farm cases:** A series of Tax Court cases involved class members who unsuccessfully sought employment with State Farm General Insurance Company (State Farm).<sup>18</sup> The class alleged discrimination, based on sex, in violation of Title VII of the 1964 Civil Rights Act. State Farm entered into a settlement agreement with class members, under which each member received a substantial sum.<sup>19</sup> The settlement agreement specifically stated that the payments were being made inclusive of attorneys' fees and costs, which the class members were

<sup>11</sup> *Benci-Woodward*, note 1 supra.

<sup>12</sup> *Eirhart v. Libbey-Owens-Ford Co.*, 726 F.Supp 700 (ND IL 1989), aff'd, 996 F.2d 837 (7th Cir. 1993).

<sup>13</sup> See *Brian Nelson*, TC Summ. Op. 2001-44; *Kevin Hamblin*, TC Summ. Op. 2001-73; *Michael Fawcett*, TC Summ. Op. 2001-65; and *Richard Waters*, TC Summ. Op. 2001-46. Of course, under Sec. 7463(b), Tax Court summary opinions may not be treated as precedent.

<sup>14</sup> See *Nelson*, note 13 supra.

<sup>15</sup> *Kenseth*, note 1 supra.

<sup>16</sup> IRS Letter Rulings 200222001 (2/28/02), 200316040 (4/18/03), 200106021 (11/7/01) and 200025023 (3/22/00). Of course, under Sec. 6110(k)(3), letter rulings may not be used or cited as precedent, but they can be very helpful in deducing the Service's current position on particular tax matters.

<sup>17</sup> Rev. Rul. 80-364, 1980-2 CB 294.

<sup>18</sup> See, e.g., *Taylor Miller*, TC Memo 2001-55 and *William Westmiller*, TC Memo 1998-140, and cases cited therein (collectively, the "State Farm Cases").

<sup>19</sup> See *Kraszewski*, 912 F.2d 1182 (9th Cir. 1990).

entitled to as prevailing plaintiffs.<sup>20</sup> It appears the payment of attorneys' fees in these cases was not under a common fund theory of recovery. Not surprisingly, the IRS contended that the attorneys' fees recovered by the plaintiff class members were includible in their gross income, and the Tax Court agreed.

**McKean:** In *McKean*,<sup>21</sup> the Court of Federal Claims granted a motion for summary judgment to members of an opt-out class action, permitting them to exclude from gross income their pro-rata share of attorneys' fees awarded to the class in a suit brought under Title VII of the 1964 Civil Rights Act. In granting the class's motion for summary judgment, the court specifically noted that it was doing so merely because the government failed to challenge the motion. This begs the question: did the court truly agree with the class's position, or did it merely grant the motion because the government failed to question it? Unfortunately, the facts do not provide sufficient information to determine whether the recovery was paid under a common fund theory. The Service has not officially responded to the *McKean* outcome, which might mean that it would agree with the court's holding if the attorneys' fees were paid out under a common fund theory of recovery.

**Eirhart:** In *Eirhart v. Libbey-Owens-Ford Co.*, 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 of the Civil Rights Act of 1964 did not result in gross income to the class members, some of whom remained unknown. It is worth noting that in *Eirhart*, the funds were paid through a common fund. This seems to be an important factor in distinguishing the results from, e.g., the State Farm Cases, which appear not to have been paid through a common fund.

### Reconciling Opt-in and Opt-out Actions

This entire area of the tax law is extremely convoluted. Although this is true for the entire attorneys' fee debacle, it is especially egregious in the case of class actions. Most class action plaintiffs do not realize they could potentially be taxed on their proportionate share of the millions in attorneys' fees routinely recovered by class members. For that matter, many class action plaintiffs' attorneys are completely oblivious to this possible result.

What happens in a class action setting in which a small amount of damages are recovered (which is not uncommon), along with substantial attorneys' fees?

**Example 2:** *D*, a class of 100 plaintiffs, recovers a \$100 million nonbusiness judgment, including \$80 million in attorneys' fees. If the class members are required to recognize their proportionate share of the gross amount, and are collectively taxed on the entire \$100 million recovery, they will be entitled to miscellaneous itemized deductions (subject to the 2%-of-AGI floor and total disallowance for AMT purposes) for the legal fees. This results in each class member owing \$276,500 in Federal income tax on his or her proportionate share of the recovery (assuming married filing jointly status). Of this amount, over \$75,000 stems from the AMT.

The truly staggering result here is that each class member will actually end up losing \$76,500. How? Each class member is allocated \$1 million gross income and can deduct a proportionate share of recovered attorneys' fees, \$800,000. From a cashflow standpoint, that yields \$200,000 in net positive cashflow. Subtracting out the tax leaves a \$76,500 negative cashflow.<sup>22</sup> It does not seem fair for a class action plaintiff to receive a favorable verdict in a lawsuit and then end up paying more in Federal income tax than he or she recovered.

In contrast, if each class member in Example 2 above was only required to include the \$200,000 net amount in gross income, he or she would have owed a mere \$47,025 in Federal income tax—a \$229,475 difference; this is exactly what could happen in a minority versus a majority jurisdiction.

In attempting to reconcile the different results reached by the various cases discussed in this article, it is important to differentiate opt-in class actions from opt-out class actions. This includes further distinguishing attorneys' fees in opt-out class actions paid under the common fund theory of recovery from those not paid out under this theory. (Of course, it is appropriate to ask whether class action attorneys or their clients, or even tax lawyers, can fairly address this kind of nitpicking.)

In differentiating opt-in class actions from opt-out class actions, it is also helpful to compare the results reached by the court in *Sinyard* with the results in *Eirhart*. In *Sinyard*, the court distinguished *Eirhart*, because it was based on a common fund theory that appears to apply only to opt-out class actions in which all class members have not yet been identified at the time the fees are awarded, and the class members are not contractually obligated to compensate class counsel. In opt-out class actions, additional class members may later be identified and held responsible for a portion of the legal fees. Accordingly, it is not unreasonable to treat the funds recovered and used to pay attorneys' fees as nontaxable to the class members.

In opt-in class actions, such as those brought under the FLSA, ADEA or EPA, all class plaintiffs are identified when the class is closed; potential plaintiffs who fail to join the class are ineligible to share in any recovery. As a result, the recovery of attorneys' fees by opt-in class members generally constitutes gross income to the class members, but will qualify the class members for a miscellaneous itemized deduction, sub-

<sup>20</sup> See, e.g., *Neil Hardin*, TC Memo 1998-202.

<sup>21</sup> *Arthur McKean*, 33 Fed. Cl. 535 (1995).

<sup>22</sup> This example may seem far-fetched, but it actually happens; see *Spina v. Forest Preserve District of Cook County*, 207 FSupp 2d 764 (ND IL 2002) (a

Chicago police officer won a sex discrimination suit, only to find that her recovery resulted in her having to pay \$99,000 more in taxes than she actually recovered).

ject to the 2%-of-AGI floor and complete AMT disallowance.

As to differentiating attorneys' fees in opt-out class actions paid out under the common fund theory from those not paid out under that theory, the former are generally not includible in the opt-out class members' gross income. Attorneys' fees recovered by opt-out class members in noncommon fund recoveries are includible in the opt-out class members' gross income.

In the case of attorneys' fees paid under a common fund theory of recovery, generally, the attorneys' fees are awarded directly to the class counsel, based on judicial precedent.<sup>23</sup> The Service has held that this does not result in gross income to the class members, assuming the class members

did not individually agree to compensate the attorneys.<sup>24</sup> This result can be reconciled with that in noncommon fund opt-out recoveries, in that these plaintiffs generally individually agree to compensate class counsel, and accordingly have income under *Old Colony Trust* when the attorneys' fees are paid to class counsel.

### Conclusion

Admittedly, the facts in many of these attorneys' fee cases vary dramatically. In any event, tax advisers should make sure that separate Forms 1099 are issued to class counsel and plaintiffs. Also, under current law, it can be critically important for class members not to sign a fee agreement with class

counsel. As to the award of attorneys' fees, a practitioner should petition the court to award the attorneys' fees. If the attorneys are directly entitled to the attorneys' fees (rather than the class members), a strong argument exists that the recovered attorneys' fees are not income to the class members. Vitaly important, the contingent fee agreement should specify in strong terms when the interest in the case is assigned. Also, the attorneys' lien law in the state can be helpful in some cases, depending on the circuit in which the case is situated. Finally, still unclear is how the Supreme Court's upcoming review of *Banks* and *Banaitis* (nonclass action suits) will affect these strategies and the taxation of class action fee awards in general. **TTA**

<sup>23</sup> Under the common fund theory of recovery, class counsel may petition the court directly for attorneys' fees; see, e.g., *Boeing v. Van Gemert*, 444 US 472, 478 (1980).

<sup>24</sup> See IRS Letter Rulings 200222001, 200316040, 200106021 and 200025023, note 16 supra.