Class Action Attorney Fees: Even Bigger Tax Problems?

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Looking for inequity and absurdity in our tax system? You needn't look any further. It is no secret that the Circuit Courts of Appeal do not agree on the tax treatment of contingent attorney fees recovered by plaintiffs. The First, Fourth, Seventh, Eighth, Ninth, Tenth, and Federal Circuits (the Majority) have held that contingent attorneys' fees constitute gross income to the recovering plaintiff.[1] The Fifth, Sixth, and Eleventh Circuits (the Minority) have held that contingent attorneys' fees do not constitute gross income to the recovering plaintiff.[2] Tax Analysts publications have long noted the split in the circuits and the legislative efforts that have thus far failed to correct the problem.[3] Despite this vehement split in the circuits, the Supreme Court has failed to reconcile these markedly different positions, denying *certiorari* in *Benci-Woodward v. Commissioner*,[4] *Coady v. Commissioner*,[5] *Hukkanen-Campbell v. Commissioner*,[6] and *Sinyard v. Rossotti*.[7]

[1]*See Alexander v. Commissioner*, 72 F.3d 938, *Doc 96-602 (21 pages), 96 TNT 1-74* (1st Cir. 1995); *Young v. Commissioner*, 240 F.3d 369, *Doc 2001-5150 (21 original pages), 2001 TNT 36-11* (4th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3d 881, *Doc 2001-21203 (4 original pages), 2001 TNT 154-9* (7th Cir. 2001); *Bagley v. Commissioner*, 121 F.3d 393 (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 (7 original pages), 2000 TNT 144-8* (9th Cir. 2000), *cert. denied* 531 U.S. 1112 (2001); *Coady v. Commissioner*, 213 F.3d 1187, *Doc 2000-16766 (7 original pages), 2000 TNT 117-9* (9th Cir. 2000), *cert. denied* 532 U.S. 972 (2001); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312, *Doc 2001-31455 (4 original pages), 2001 TNT 247-75* (10th Cir. 2001), *cert. denied* 535 U.S. 1056 (2002); and *Baylin v. Commissioner*, 43 F.3d 1451, *Doc 95-342, 95 TNT 4-23* (Fed. Cir. 1995). It is important to note that the Ninth Circuit now seems to be split on this issue. *See Banaitis v. Commissioner*, 2003 U.S. App. LEXIS 17913, *Doc 2003-19359 (16 original pages), 2003 TNT 167-5* (9th Cir. Aug. 27, 2003) (holding that under Oregon law recovered attorneys' fees are not gross income to the plaintiff); *compare Benci-Woodward* and *Sinyard v. Commissioner*, 268 F.3d 756, *Doc 2001-24862 (15 original pages), 2001 TNT 188-11* (9th Cir. 2001), *aff'g* 76 TCM 654, *Doc 98-29997 (14 pages), 98 TNT 195-10* (1998).

[2]*See Srivastava v. Commissioner*, 220 F.3d 353, *Doc 2000-20090 (16 original pages), 2000 TNT 145-9* (5th Cir. 2000); *Estate of Clarks v. Commissioner*, 202 F.3d 854, *Doc 2000-1776 (7 original pages), 2000 TNT 10-21* (6th Cir. 2000); and *Davis v. Commissioner*, 210 F.3d 1346, *Doc 2000-12246 (5 original pages), 2000 TNT 86-7* (11th Cir. 2000).

[3]*See* Robert W. Wood, "Tax Treatment of Attorneys' Fees," *Doc 2003-11996 (10 original pages), 2003 TNT 94-128*; *see also* Robert W. Wood, "More Confusion on Tax Treatment of Attorneys' Fees: Whose Law Applies?" *Tax Notes*, June 16, 2003, p. 1651.

[4]Note 1 *supra*.

[5]Note 1 *supra*.

[6]Note 1 *supra*.

[7]Note 1 *supra*.

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I. The Shocking Reality

Due to a variety of oddities in our tax system (most notably the AMT), there is a dramatic tax difference between the result obtained when a plaintiff is taxed on the gross amount of a settlement rather than on an amount net of recovered attorney fees. This sad reality is perhaps best illustrated by way of example. Let's assume that a taxpayer recovers a $1 million settlement (which is not related to a trade or business), inclusive of attorney fees. If the taxpayer is required to recognize the gross amount, he will be taxed on the entire $1 million recovery, and he will be entitled to a miscellaneous itemized deduction (subject to a 2-percent-of-AGI floor) for the amount of the legal fees recovered (assume $400,000). This results in the taxpayer owing $276,500 in federal income tax on the recovery (this assumes the taxpayer is married filing jointly). Of this amount, more than $75,000 stems from the AMT. In stark contrast, if the taxpayer is required to include only the net amount of $600,000 in gross income, he will owe a mere $181,881.50 in federal income tax. That is a whopping $94,618.50 difference! That doesn't seem fair, does it?

If instead, the plaintiff's case arose out of trade or business, the plaintiff would normally be able to deduct the entire amount of contingent attorneys' fees recovered. The Internal Revenue Code does not expressly provide a deduction for damages or settlement payments. However, payments of damages or settlement payments in connection with a trade or business are deductible under the general business expense provisions of section 162.

To be deductible under section 162, damages or settlement payments must meet the following requirements: (1) it must be ordinary, necessary, and reasonable expenses; (2) it must be paid or incurred during the tax year for which a deduction is sought; (3) it must be directly connected or proximately result from the taxpayer's trade or business; (4) it must be an expense rather than a capital expenditure; (5) it must not be personal in nature; (6) it must be paid by the person to whom the services are rendered; and (7) the deductibility of the expense must not be contrary to public policy.

II. How Did We Get Into This Mess?

The Sixth Circuit in *Estate of Clarks*[8] goes through the authority in this area, commencing with *Cotnam v. Commissioner*[9] and the more recent cases thereafter. In *Cotnam*, as most readers know, the Fifth Circuit held that the amount of a contingent fee paid out of a judgment to the plaintiff's attorneys was not income to the plaintiff. Under Alabama State law, which applied in *Cotnam*, a contingency-fee contract operates as a lien on the recovery. The Alabama code provided that attorneys at law will have the same right and power over suits, judgments, and decrees to enforce their liens as their clients had or may have for the amount due. That gave the *Cotnam* court solid ground to say there had been a transfer of part of the plaintiff's claim and that any recovery by the lawyers on that portion of the claim was simply gross income to them.[10] The Eleventh Circuit, which was made up of a portion of the Fifth Circuit when the Fifth was split in two, followed the *Cotnam* result, but without any analysis.[11]

The Sixth Circuit has followed the *Cotnam* result, too, but it did so by looking to the vicissitudes of state law. In *Estate of Clarks*, the relevant state law was Michigan law, and the court said that the lien law there operated in more or less the same way as the Alabama lien law in *Cotnam*. Not surprisingly, most of the law concerning attorneys' liens goes back many years. Indeed, the Sixth Circuit had to cite a case dealing with attorneys' liens going back to 1889. The court found that these hoary cases generally supported treating the attorney as having an ownership interest in that portion of the case.

Yet, the Sixth Circuit noted that a more recent decision by the Court of Appeals for the Federal Circuit reached a contrary result. In *Baylin v. United States*,[12] the Federal Circuit did not follow *Cotnam*. The *Baylin* court held that the contingent fee portion of the settlement from a condemnation proceeding that was paid directly to the lawyer was still income to the plaintiff. The *Baylin* court mentioned the Supreme Court's liberal interpretation of "gross income," and then went on to find that even though the plaintiff never had actual possession of the funds that went to the lawyer, the plaintiff received the benefit of those funds in that they discharged an obligation the plaintiff owed to the lawyer. This is the "discharge of indebtedness" theory under which some of the cases in this area are decided.[13] It is always surprising we don't see more of this theory.

The Sixth Circuit in *Estate of Clarks* went on to analyze the *Baylin* court's rule. *Baylin*, interestingly, relied on the two early Supreme Court cases, *Lucas v. Earl*[14] and *Helvering v. Horst*.[15] These cases involved assignments of income by persons who had earned the income, but not yet received it. To make matters worse, they "assigned" the income to related parties — family members. In *Earl* and *Horst*, the taxpayers were considered to have taxable income even though they never had actual possession of the funds.

After going through some pains to recite the individualized facts of the *Earl* and *Horst* cases, the Sixth Circuit said that in both of those cases each taxpayer earned and created the right to receive and enjoy the benefit of the income before any assignment. The income assigned to the assignee was already earned, vested, and relatively certain to be paid to the assignor.

[8]Note 2 *supra*.

[9]263 F.2d 119 (5th Cir. 1959).

[10]*Id.* at 125.

[11]*Davis v. Commissioner*, note 2 *supra*.

[12]Note 1 *supra*.

[13]*See, e.g., Sinyard v. Commissioner*, note 1 *supra*, *citing Old Colony Trust v. Commissioner*, 279 U.S. 716 (1929) (discussed below).

[14]281 U.S. 111 (1930).

[15]311 U.S. 112 (1940).

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The court in *Estate of Clarks* does a good job of distinguishing both the *Earl* and *Horst* cases, and comes back to the notion that the *Cotnam* court had it right all along. After all, said the court, the majority in the *Cotnam* decision correctly distinguished *Lucas* and *Horst*. In *Estate of Clarks*, as in *Cotnam*, the value of the taxpayer's lawsuit was entirely speculative and dependent on the services of his counsel. The claims simply amounted to an intangible contingent expectancy.

Indeed, the only economic benefit Clarks could derive from his claim against the defendant in state court was to use the contingent part of it to help him collect the remainder. Like an interest in a partnership or a joint venture, said the court, Clarks contracted for services and assigned his lawyer a one-third interest in the "venture" so that he might have a chance to recover the remaining two-thirds. Just as in the *Cotnam* case, said the Sixth Circuit, the assignments that Clarks' lawyer received operated as a lien on a portion the judgment sought to be recovered, thus transferring ownership of that portion of the judgment (when it eventually became a judgment) to the attorney.

The Sixth Circuit in *Estate of Clarks* has given an enormously strong endorsement of the *Cotnam* theory, and an equally strong statement about the scope of the assignment of income doctrine and the seminal cases (*Lucas* and *Horst*) from which all of this assignment of income phobia sprang. In firmly putting to rest the irrelevance of the *Lucas* and *Horst* lines of authority the court held that the assignment of income doctrine, certainly as pronounced in the *Lucas* and *Horst* cases, involved gratuitous transfers, and involved timing (after the income was earned) that was radically different from virtually all of these attorneys' fee cases.

Ultimately, the question of whether contingent attorneys' fees recovered by a plaintiff are includible in the plaintiff's gross income appears to turn on whether (1) there is direct payment of attorneys' fees, so that the recovering plaintiff never touches the contingent fees; (2) the attorneys' fees were paid under court-order, so that it does not appear that there is any discharge of debt to the plaintiff; and (3) there is a strong attorneys' lien law which gives the plaintiff's attorney a right in and to the fees, negating any constructive receipt by the plaintiff. The last factor is arguably the most important one, as many cases appear to turn on this issue.[16] This is problematic because in many situations it is unclear how you determine which state's law applies.[17]

III. Class Action Nuances

What about class actions? Do the same rules apply? Are the often enormous attorney fees paid to class counsel gross income to class members? Does it matter what kind of a class action is involved? Is there a different result if the plaintiff actually elects to join the class instead of merely failing to opt out of it? Some of these questions are plaguing taxpayers, and some are affecting lawyers. All of these questions should be a matter of concern for the IRS. This article will attempt to answer these and other questions in the pages that follow. The IRS and the circuit courts are currently taking different approaches to the tax treatment of contingent attorneys' fees recovered by plaintiffs in opt-in class action lawsuits vs. opt-out class action lawsuits.

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),[18] the Age Discrimination in Employment Act (ADEA),[19] and the Equal Pay Act (EPA),[20] require that potential plaintiffs opt-in if they wish to participate in the litigation and share in any recovery.

On the other hand, 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 of the class. This will preserve any individual cause of action they might have against the defendant, and it will prevent them from being bound by any settlement or judgment. Beginning with the important opt-in vs. opt-out dichotomy, we examine the taxation of contingent attorneys' fees in these two technically different but factually quite similar types of class actions. Historically, some commentators have argued that the Service has been somewhat lackadaisical in its enforcement in this area. As the saying goes, that was then, this is now. *Sinyard v. Commissioner*[21] (discussed below) dispels any misconceptions that might be lingering as to how the Service feels about this issue today.

IV. Contingent Fees in Opt-In Class Actions

A. *Sinyard v. Commissioner*

In *Sinyard*[22] the Ninth Circuit agreed with the Tax Court's determination that contingent attorney fees recovered by a plaintiff in an opt-in class action are includible in the plaintiff's gross income. The Service argued that the attorney fees recovered in an opt-in class action brought under the ADEA resulted in gross income to the plaintiff. Of course, the government conceded that the plaintiff was entitled to a miscellaneous itemized deduction, subject to a 2-percent-of-AGI floor and disallowance for AMT purposes. On the other hand, the Sinyards asserted that because the class action defendant was liable to pay the attorney fees under court order they had no gross income when the defendant actually paid its debt.[23] Based on *Old Colony*

[16] *See, e.g., Benci-Woodward v. Commissioner*, note 1 *supra*; *compare Estate of Clarks v. Commissioner*, note 2 *supra*.

[17] *See* Robert W. Wood, "More Confusion on Tax Treatment of Attorneys' Fees: Whose Law Applies?," *Tax Notes*, June 16, 2003, p. 1651.

[18] 29 U.S.C. sections 201, *et seq.*

[19] 29 U.S.C. sections 621, *et seq.*

[20] 29 U.S.C. sections 206, *et seq.*

[21] Note 1 *supra*.

[22] *Id.*

[23] 268 F.3d 756 at 758.

Trust,[24] the court stated, "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed."[25]

The court went on to note that under the ADEA[26] the prevailing plaintiff, not the prevailing plaintiff's counsel, is entitled to attorney fees.[27] The Sinyards had personally executed an agreement with class counsel, agreeing to pay them for their services. Citing *Benci-Woodward v. Commissioner*,[28] the court found the Sinyards to be in constructive receipt of the funds paid to class counsel, and held the amount was includible in their gross income.[29]

The Tax Court differentiated *Eirhart v. Libbey-Owens-Ford Co.*[30] from *Sinyard*, noting that *Eirhart* was based on a common fund theory that appears to apply only to opt-out class actions where 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 the class counsel.[31] The Tax Court reasoned that in the case of opt-out class actions, there may be policy reasons to treat recovered attorney fees as nontaxable to the class members; for example, additional members of the class may later be identified and held responsible for a portion of the legal fees.[32] Hence, says the Tax Court, 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 being finalized, and potential plaintiffs who failed to join the class are ineligible to share in any recovery.

B. The 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.[33] In a settlement with the opt-in class members, Payless agreed to pay class members varying amounts to settle their claims. The court held that the recovered attorney fees were includible in the gross income of the class members.[34] The Tax Court reasoned that the taxpayers did not physically receive the portion of the settlement proceeds paid to the attorneys, but they did receive benefits from those funds in the form of payment for services required to obtain the settlement.[35] The taxpayers were accordingly permitted to deduct the recovered attorney fees as a miscellaneous itemized deduction, subject to a 2-percent-of-AGI floor and complete disallowance for AMT purposes.

C. *Kenseth v. Commissioner*

The Tax Court in *Kenseth*[36] held that contingent attorney fees recovered by a plaintiff in an opt-in class action are includible in the plaintiff's gross income, notwithstanding the fact that the recovering class members had very little control over the disbursement of the settlement funds. The Service contended that the attorney fees recovered by the plaintiff, a member of an opt-in class action brought under the ADEA, resulted in gross income to the plaintiff, but the government conceded that the plaintiff was entitled to a miscellaneous itemized deduction, subject to a 2-percent-of-AGI floor and complete disallowance for AMT purposes. As the Tax Court noted, under the ADEA the prevailing plaintiff, not the prevailing plaintiff's counsel, is entitled to attorney fees. Moreover, Kenseth had personally executed a contingent fee agreement with class counsel, agreeing to pay them for their services.

Judge Ruwe, writing for the majority, found Kenseth in constructive receipt of the funds paid to class counsel, and held the amount was 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). The Tax Court majority specifically declined to follow the reasoning set forth in *Estate of Clarks v. United States*[37] and *Cotnam v. Commissioner.*[38] Instead, the Tax Court chose to follow its own decision in *O'Brien v. Commissioner*.[39] In arriving at its holding, the Tax Court specifically declined to entertain Kenseth's assertions that he had insufficient rein over his own cause of action to be found in constructive receipt of

[24]*Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929).

[25]268 F.3d 756 at 758, *citing* 279 U.S. 716 at 729.

[26]29 U.S.C. section 626(b) (expressly incorporating provisions pertaining to attorneys' fees under the FLSA, 29 U.S.C. section 216(b)).

[27]268 F.3d 756 at 759.

[28]Note 1 *supra*.

[29]268 F.3d 756 at 759.

[30]726 F. Supp. 700 (N.D. Ill. 1989), *aff'd* 996 F.2d 837 (7th Cir. 1993) (discussed below).

[31]T.C. Memo. 1998-364, *Doc 98-29997 (14 pages), 98 TNT 195-10.*

[32]*Id*.

[33]*See Nelson v. Commissioner*, T.C. Summary Opinion 2001-44, *Doc 2001-9589 (12 original pages), 2001 TNT 64-12; Hamblin v. Commissioner*, T.C. Summary Opinion 2001-73, *Doc 2001-14544 (13 original pages), 2001 TNT 100-19; Fawcett v. Commissioner*, T.C. Summary Opinion 2001-65, *Doc 2001-12571 (11 original pages), 2001 TNT 86-11; Waters v. Commissioner*, T.C. Summary Opinion 2001-46, *Doc 2001-9746 (11 original pages), 2001 TNT 65-16*. Of course, under section 7463(b), Tax Court summary opinions may not be treated as precedent.

[34]The attorney fees in question were recovered on a pro rata basis; each opt-in class member was allocated approximately 34.53 percent of his or her settlement amount in attorney fees.

[35]*Nelson v. Commissioner*, note 33 *supra*.

[36]114 T.C. 399, *Doc 2000-14845 (98 original pages), 2000 TNT 102-6* (2000). This was a reviewed opinion, meaning that the opinion prepared by the trial judge was examined by the entire Tax Court, in this case by 13 judges (holding 8-5 in favor of the IRS). *See* Taylor, Simonson, Winter, and Seery, *Tax Court Practice*, section 12.01(d) (7th Ed. 1990). Only the Chief Judge of the Tax Court can decide whether an opinion will be reviewed by the full court. Section 7458. In fact, very few Tax Court cases actually receive this treatment. In the majority of cases, a single Tax Court judge decides the case. According to the Tax Court's fiscal year statistical information, only a tiny percentage of cases are reviewed by the court. Between 1982 and 1991, only 1.5 percent of the cases were reviewed by the court. *See United States Tax Court Fiscal Year 1991 Statistical Information*, at p. 5 (1992).

[37]Note 2 *supra*.

[38]Note 9 *supra*.

[39]38 T.C. 707 (1962), *aff'd per curiam* 319 F.2d 532 (3rd Cir. 1963).

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the portion of the settlement funds paid to class counsel under the terms of the contingent-fee agreement.

V. Contingent Fees in Opt-Out Class Actions

A. IRS Guidance

In a series of private letter rulings,[40] the Service has ruled that contingent attorney fees paid from qualified settlement funds, as defined by section 468B and Treas. reg. section 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 attorney fees paid to plaintiffs' counsel were not includible in the plaintiffs' gross income. The Service noted that this result was consistent with its holding in Situation 3 of Rev. Rul. 80-364.[41]

In Situation 3 of Rev. Rul. 80-364, 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 whereby the employer agreed to pay damages and attorney fees to the union. The union thereafter paid its counsel, and disbursed the remaining funds to its members. The Service held that the attorney fees were not includible in the union members' gross income. Instead, the IRS characterized the payment of attorneys' fees as a reimbursement for expenses incurred by the union to enforce a collective bargaining agreement. In a recent Chief Counsel Advisory[42] the Service reiterated its holding in Rev. Rul. 80-364 and concurred with the *Sinyard*[43] court, stating, "[l]egal 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]

B. The State Farm Cases

There has been a series of Tax Court cases involving class members who unsuccessfully sought employment with State Farm General Insurance Company (State Farm).[45] The members of the class alleged discrimination, based on sex, in violation of Title VII of the 1964 Civil Rights Act.[46] State Farm entered into a settlement agreement with class members, under which each member received a substantial sum to settle his or her claim.[47] The settlement agreement specifically stated that the payments were being made inclusive of attorney fees and costs, which the class members were entitled to as prevailing plaintiffs.[48] It appears the payment of attorney fees in this case was not under a common fund theory of recovery.

Not surprisingly, the IRS asserted that the attorney fees recovered by the plaintiff class members were includible in the gross income of the class members. The Service further contended that the recovered attorney fees were deductible by class members as miscellaneous itemized deductions, subject to a 2-percent-of-AGI floor and complete disallowance for AMT purposes. The Tax Court agreed with the Service, stating:

> Both the Court of Appeals for the Ninth Circuit and this Court have consistently held that contingent fees paid to recover a claim to income are not excluded in computing the gross income from the recovery, not even in a class action such as in the case at hand, where the claimant retains even less control over the prosecution and settlement of the claim than she would in ordinary one-on-one litigation.[49]

C. *McKean v. Commissioner*

In *McKean*,[50] 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

[40]LTRs 200222001, *Doc 2002-13011 (9 original pages), 2002 TNT 106-58*; 200316040, *Doc 2003-9910 (9 original pages), 2003 TNT 76-57*; 200106021, *Doc 2001-4001 (7 original pages), 2001 TNT 29-46*; 200025023, *Doc 2000-17353 (8 original pages), 2000 TNT 123-42*. Of course, under section 6110(k)(3), private letter rulings may not be used or cited as precedent, but they can be very helpful in deducing the Service's current position with respect to particular tax matters.

[41]1980-2 C.B. 294 (Situation 3).

[42]ILM 200246015, *Doc 2002-25565 (3 original pages), 2002 TNT 222-43*. Of course, under section 6110(k)(3) Chief Counsel Advisory Opinions may not be used or cited as precedent, but they can be very helpful in deducing the Service's current position with respect to particular tax matters.

[43]Note 1 *supra*.

[44]Note 42 *supra*.

[45]*See Miller v. Commissioner*, T.C. Memo. 2001-55, *Doc 2001-6608 (44 original pages), 2001 TNT 45-14*; *Westmiller v. Commissioner*, T.C. Memo. 1998-140, *Doc 98-12482 (5 pages), 98 TNT 73-8*; *Reiher v. Commissioner*, T.C. Memo. 1998-75, *Doc 98-7103 (4 pages), 98 TNT 36-9*; *Easter v. Commissioner*, T.C. Memo. 1998-8, *Doc 98-1307 (7 pages), 98 TNT 5-5*; *Brewer v. Commissioner*, T.C. Memo. 1997-542, *97 TNT 237-6, Doc 97-33119 (11 pages), aff'd without published opinion* 172 F.3d 875, *Doc 1999-10962 (3 original pages), 1999 TNT 64-74* (9th Cir. 1999); *Gillette v. Commissioner*, T.C. Memo. 1997-301, *Doc 97-19285 (4 pages), 97 TNT 126-7*; *Hayes v. Commissioner*, T.C. Memo. 1997-213, *Doc 97-12666 (5 pages), 97 TNT 89-7*; *Hardin v. Commissioner*, T.C. Memo. 1997-202, *Doc 97-12465 (12 pages), 97 TNT 87-6*; *Raney v. Commissioner*, T.C. Memo. 1997-200, *Doc 97-12239 (10 pages), 97 TNT 85-8*; *Clark v. Commissioner*, T.C. Memo. 1997-156, *Doc 97-9100 (12 pages), 97 TNT 62-5*; *Berst v. Commissioner*, T.C. Memo. 1997-137, *Doc 97-7581 (6 pages), 97 TNT 52-9*; *Martinez v. Commissioner*, T.C. Memo. 1997-126, *Doc 97-6984 (7 pages), 97 TNT 48-9, aff'd without published opinion* 1998 U.S. App. Lexis 31955 (9th Cir. 1998); *Fredrickson v. Commissioner*, T.C. Memo. 1997-125, *Doc 97-6985 (8 pages), 97 TNT 48-10* (collectively the "State Farm Cases").

[46]Pub. L. 88-352, 78 Stat. 241. 253. Class actions brought under the 1964 Civil Rights Act are opt-out class actions.

[47]*See Kraszewski, et al. v. State Farm Gen. Ins. Co.*, 912 F.2d 1182 (9th Cir. 1990).

[48]*See, e.g., Hardin v. Commissioner*, note 45 *supra*.

[49]*Miller v. Commissioner*, note 45 *supra*, *comparing Estate of Clarks v. United States*, note 2 *supra*, and *Cotnam v. Commissioner*, note 9 *supra*, *with Benci-Woodward v. Commissioner*, note 1 *supra*; *Coady v. Commissioner*, note 1 *supra*; *Kenseth v. Commissioner*, note 36 *supra*; *Brewer v. Commissioner*, note 45 *supra*; *Martinez v. Commissioner*, note 45 *supra*.

[50]33 Fed. Cl. 535 (1995).

income their pro-rata share of attorney fees awarded to the class in a suit brought under Title VII of the 1964 Civil Rights Act.[51]

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.[52] But this leaves unanswered the question of whether the court truly agreed with the class's position or merely granted the motion because the government failed to question it. Unfortunately, the facts of the case do not provide sufficient information to determine whether the recovery was paid under a common fund theory. There has been no official response from the Service on the outcome of *McKean*. One might surmise that it would agree with the court's holding if the attorney fees were paid out under a common fund theory of recovery.

D. *Eirhart v. Libbey-Owens-Ford Company*

In *Eirhart*,[53] an action to which the IRS was not a party, the court held that separately deposited funds paid to opt-out class members in settlement of their 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 cases like the State Farm cases, which appear not to have been paid through a common fund.

VI. Reconciling the Mess

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

Let's see how this might work out in a class action setting where a small amount of damages are recovered (which is not uncommon) along with a substantial amount of attorney fees. Assume that a class of 100 plaintiffs recovers a $100 million judgment (which is not related to a trade or business), inclusive of attorney fees. If the class members are required to recognize their proportionate share of the gross amount, they will collectively be taxed on the entire $100 million recovery, and will be entitled to miscellaneous itemized deductions (subject to a 2-percent-of-AGI floor and total disallowance for AMT purposes) for the amount of the legal fees recovered (assume $80 million). This results in each member of the class owing $276,500 in federal income tax on his proportionate share of the recovery (this assumes the taxpayer is married filing jointly). Of this amount, more than $213,000 stems from the AMT.

The truly staggering result here is that each class member will actually end up losing $76,500! That's right, each class member will actually end up in the hole to the tune of $76,500! How does this happen? Each class member is allocated $1 million in gross income. Each class member is allowed to deduct a proportionate share of recovered attorney fees, $800,000. From a cash-flow standpoint, that yields $200,000 in net positive cash flow. Of course, when you chalk up $276,500 in federal income taxes, you end up in the red by $76,500. It doesn't seem at all fair to receive a favorable verdict in a lawsuit and then end up paying more in federal income tax than you recovered. What ever happened to equity in our tax system? Adam Smith would roll over in his grave! This result is nothing short of outrageous. It seems somehow unamerican to be the prevailing party in a lawsuit and actually end up in the red when the smoke clears (talk about smoke and mirrors). It's high time for our friends on Capitol Hill to do something about this problem.

In stark contrast, if each member of the class is required to include only the net amount of $200,000 in gross income, he will owe a mere $42,297.50 in federal income tax. That is a whopping $234,202.50 difference! That doesn't seem fair, does it? But this is exactly what would happen if you lived in a Minority jurisdiction and not 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. It is also important to further differentiate attorney fees in opt-out class actions paid out under the common fund theory of recovery from those not paid out under a common fund theory of recovery. 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 helpful to compare the results reached by the court in *Sinyard*[54] with the results in *Eirhart*.[55] The *Sinyard* court distinguished *Eirhart* on the grounds that it was based on a common fund theory that appears to apply only to opt-out class actions where 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.[56] In the case of opt-out class actions, additional members of the class may later be identified and held responsible for a portion of the legal fees.[57] Accordingly, it is not unreasonable to treat the funds recovered

[51]Pub. L. 88-352, 78 Stat. 241. 253. Class actions brought under the 1964 Civil Rights Act are opt-out class actions.

[52]33 Fed. Cl. 535, 539.

[53]996 F.2d 837 (7th Cir. 1993).

[54]Note 1 *supra*.

[55]Note 30 *supra*.

[56]Note 31 *supra*.

[57]*Id*.

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and used to pay attorney fees as nontaxable to the class members.[58]

In direct contrast, 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, and potential plaintiffs who fail to join the class are ineligible to share in any recovery. As a result, the recovery of attorney 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, subject to a 2-percent-of-AGI floor and complete disallowance for AMT purposes.[59]

As to differentiating attorney fees in opt-out class actions paid out under the common fund theory from those not paid out under a common fund theory, attorney fees paid out under a common fund theory are generally not includible in the opt-out class members' gross income. Attorney fees recovered by opt-out class members in non-common fund recoveries are includible in the opt-out class members' gross income.

In the case of attorney fees paid under a common fund theory of recovery, generally the attorney fees are awarded directly to the class counsel based on judicial precedent.[60] The IRS has held that does not result in gross income to the class members, assuming the class members did not individually agree to compensate the attorneys.[61] This result can be reconciled with the result in non-common fund opt-out recoveries in that these plaintiffs generally individually agree to compensate class counsel, and accordingly have income under the rule of *Old Colony Trust*[62] when the attorney fees are paid to class counsel.

VII. Any Advice?

Admittedly, the facts in many of these attorney fee cases vary dramatically. Advisers and taxpayers alike should be alert to some of the traps. To avoid the pitfalls of assignment of income cases such as *Horst* and *Earl*, direct payment of attorneys fees is still the best course of action. *Estate of Clarks* and its progeny distinguish *Horst* and *Earl* on the grounds that the income assigned to the assignees in those cases was already earned, vested, and relatively certain to be paid to the assignor. This is not true in most cases involving the attorney fee issue. In these cases the value of the taxpayer's lawsuit is arguably entirely speculative and dependent on the services of counsel. Even so, many other courts have not distinguished *Horst* and *Earl* in this context.[63] As easy as it is to facilitate direct payment of attorneys' fees, it is probably a good idea to take a page out of Nike's book and "just do it."

Also, it is critically important for class members not to sign the fee agreement with class counsel. It is difficult for the Service to argue that you have income from discharge of indebtedness if you never had any debt to be discharged from, isn't it? As to the award of attorney fees, if at all possible, petition the court to award the attorney fees. If the attorneys are directly entitled to the attorney fees (rather than the class members) a strong argument exists that the recovered attorney fees are not income to the class members.[64]

It is also vitally important that the contingent-fee agreement specify in strong terms when the interest in the case is assigned. The attorneys' lien law in the state can be helpful in some cases. It is somewhat ironic that many of the cases in this area turn on this issue and most attorneys are not even familiar with how attorneys' liens are manifested. This will continue to be a volatile area. Taxpayers and their advisers (and certainly litigators, too) should be very careful. They should obtain tax advice *before* any settlement is reached. They should be careful how the payments are made. Of course, they should also be careful what the settlement agreement specifies about who is going to get any Forms 1099 or W-2. The forms issue (with its audit risk controls) can have an enormous impact on the ultimate result of any later dispute with the IRS.

[58] *Id.*

[59] Presumably if an opt-in class action were to be adjudicated in the Fifth, Sixth, or Eleventh Circuits, the court would follow applicable precedent in those circuits holding that the recovery of contingent attorney fees does not result in gross income to the plaintiffs. *See Srivastava v. Commissioner*, note 2 *supra*; *Estate of Clarks v. Commissioner*, note 2 *supra*; and *Davis v. Commissioner*, note 2 *supra*.

[60] Under the common fund theory of recovery, class counsel may petition the court directly for attorney fees. *See, e.g.*, *Boeing v. Van Gemert*, 444 U.S. 472, 478 (1980).

[61] *See, e.g.*, LTRs 200222001, note 40 *supra*; 200222001, note 40 *supra*; 200106021, note 40 *supra*; 200025023, note 40 *supra*.

[62] *Old Colony Trust Co. v. Commissioner,* note 24 *supra* at 729, holding "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed."

[63] *See, e.g., Coady v. Commissioner*, note 1 *supra*.

[64] *See, e.g., Kenseth v. Commissioner*, note 1 *supra*; *Sinyard v. Commissioner*, note 1 *supra* (holding that because the prevailing plaintiffs, rather than their attorneys, were entitled to court-awarded attorney fees, they must include the recovered fees in their gross income).

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