Tax Treatment of Class Action Attorneys' Fees: After *Banks*

By Robert W. Wood

Robert Wood discusses the tax treatment of class action attorneys' fees, looking specifically at the Banks decision and comparing its result with the result of the Jobs Act.

In *J.W. Banks*,[1] the Supreme Court held that contingent attorneys' fees generally represent income to the plaintiff, resolving a bitter dispute among the Circuit Courts. Unfortunately, this decision did not address all types of litigation or all fact patterns and thus provides incomplete answers to the puzzle of attorneys' fees taxation.[2] Although the Court announces that contingent attorneys' fees are income to the plaintiff, it expressly provides that this is only a general rule.

Moreover, the Supreme Court carves out several substantive issues it says it will not address. Some of these issues are huge, such as the appropriate tax treatment in cases involving injunctive relief, and in cases involving statutory fee shifting provisions. The Supreme Court implicitly creates exceptions to the general rule, but says it is not going to discuss or analyze them. In the end, the *Banks* decision may have raised more questions than it answered.

Shortly before the *Banks* decision, Congress also decided to address the tax treatment of attorneys' fees. The American Jobs Creation Act of 2004 (the "Jobs Act"),[3] provides that in employment discrimination and federal False Claims Act cases, a recovering plaintiff gets a 100-percent deduction for attorneys' fees, thus offsetting the income inclusion.[4] However, there are still numerous kinds of cases not covered by the Jobs Act, so attorneys' fee tax problems will arise in many cases for years to come.[5]

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Adverse Tax Hit

In cases not covered by the Jobs Act (which basically applies to employment cases and federal False Claims Act cases), there is a dramatic tax difference between the result obtained when a plaintiff is taxed on the gross amount of a settlement, rather than merely on his recovery net of attorneys' fees. For example, suppose a taxpayer sues for defamation and agrees to pay his lawyer 40 percent of what he recovers. He eventually recovers a $1 million settlement. He will be taxed on the entire $1 million recovery, and only entitled to a miscellaneous itemized deduction for his legal fees. This taxpayer owes $276,500 in federal income tax on the recovery (assuming he is married filing jointly). Of this amount, over $75,000 stems from the alternative minimum tax (AMT). In stark contrast, if he only included the net amount of $600,000 in gross income, he would owe only $181,881.50 in federal income tax. The difference is a whopping $94,618.50. State taxes usually make the disparity bigger, not smaller.

Congress took one important swipe at this disparity in the Jobs Act, allowing (since October 22, 2004) an "above-the-line" deduction for attorneys' fees. Where it applies, this should make a plaintiff indifferent whether the recovery is income. Unfortunately, this new super-sized deduction only applies to employment cases and federal False Claims Act cases. That leaves a huge volume of cases where tax problems to the plaintiff will still be posed by the contingent legal fees.

Attorneys' Fees in Class Actions

This attorneys' fee tax problem can be particularly serious in class actions, simply because there the ratio between the plaintiff's recovery and the attorneys' fees may be particularly skewed. Even a class member's *pro rata* share of the attorneys' fees can be grossly out of proportion to his recovery. For example, a class member may have a net recovery of $1,000 in a case, but his gross recovery (including his share of the attorneys' fees) may be $3,000. If that plaintiff must include the $3,000 in income and seek to deduct $2,000, he will pay significantly more taxes, unless this is an employment case.

Thus, it is appropriate to ask whether the often enormous attorneys' fees paid to class counsel constitute income to class members. In addressing this question, it may matter what type of a class action is involved. Historically, different approaches were taken by the IRS and the Circuit Courts in taxing attorneys' fees in opt-in versus opt-out class actions. As we'll see, the Jobs Act and the Supreme Court's *Banks* decision do little to rectify this disparity.

An opt-in case is a class action that requires individuals to take affirmative action to be included in and bound by the resulting settlement or judgment. Class actions 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. In contrast, an opt-out case is a class action which does not require individuals to take any action to be included in and bound by the resulting settlement or judgment. Potential plaintiffs in opt-out cases may opt-out of the class, and this will preserve any individual cause of action they might have against the defendant.

The IRS and the courts have generally tended to treat attorneys' fees as excludable (not taxable to class members) in opt-out cases, but as taxable (includable in class members' gross incomes) in opt-out cases. As we'll see, it is not this simple, but it is fair to call this a discernable trend. As such, it is prudent to ask how the Jobs Act and the *Banks* decision, the two most recent developments in the attorneys' fee tax puzzle, affect class actions and this trend.

Since the Jobs Act was enacted in October 2004 and the Supreme Court handed down its *Banks* decision in January 2005, no new tax case has considered the tax ramifications of either opt-in or opt-out cases. That seems to leave much uncertainty. Furthermore, as we'll see below, the Jobs Act and *Banks* may have made the contingent attorneys' fees discussions in many prior cases less relevant and perhaps even obsolete.

Tax on Attorneys' Fees in Opt-in Class Actions

In *J.T. Sinyard,*[6] the Ninth Circuit agreed with the Tax Court's determination that contingent attorneys' fees in an opt-in class action are includible in the plaintiff's gross income. The IRS argued that the attorneys' fees recovered in an opt-in class action brought under the ADEA resulted in gross income to the plaintiff. The Sinyards asserted that because the defendant was ordered to pay attorneys' fees by the court, the Sinyards had no gross income. The court disagreed.

The court went on to note that under the ADEA the prevailing plaintiff, not the prevailing plaintiff's counsel, is entitled to attorneys' fees. The Sinyards had personally executed an agreement to pay class counsel for their services. Finding the Sinyards in constructive receipt of the funds paid to class counsel, the court held the fees includible in their gross income.

The Tax Court in *Sinyard* distinguished *Eirhart v. Libbey-Owens-Ford Co.*[7] 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 where the class members are not contractually obligated to compensate class counsel. The *Sinyard* court reasoned that in opt-out class actions, there may be policy reasons to treat recovered attorneys' fees as nontaxable to the class members; *e.g.*, additional members of the class may later be identified and held responsible for a portion of the legal fees. In contrast, in an opt-in action, all class members are identified when the class is closed (long before any settlement), and potential plaintiffs who failed to join the class are ineligible to share in any recovery.

A series of Tax Court cases have been decided involving former employees of Payless Drug Stores and their Fair Labor Standards Act suits.[8] Payless agreed to pay opt-in class members, and the attorneys were separately paid. Still, the court held the attorneys' fees to be income to the class members. The Tax Court reasoned that the taxpayers did not physically receive the portion of the settlement proceeds paid to the attorneys, but they received benefits from those funds in the form of payment for services required to obtain the settlement.[9]

In *E.R. Kenseth,*[10] the court held contingent attorneys' fees in an opt-in class action were income to the plaintiff, notwithstanding the fact that the class members had very little control over the disbursement of the settlement funds. Kenseth had personally executed a contingent fee agreement with class counsel, so the court found Kenseth to be in constructive receipt of the funds paid to class counsel.

Taxation of Attorneys' Fees in Opt-out Class Actions

Opt-out cases have fared much better from a tax viewpoint. In a series of private letter rulings,[11] the IRS has ruled that contingent attorneys' fees paid from qualified settlement funds (as defined by Code Sec. 468B) do not result in gross income to opt-out class members. The IRS reasoned that individual class members had not agreed to personally compensate class counsel. This is consistent with Rev. Rul. 80-364,[12] where 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 IRS held that the attorneys' fees were not includible in the union members' gross income.

However, there are adverse decisions here, too. A series of Tax Court cases involve women who unsuccessfully sought employment with State Farm and who sued for gender discrimination violating Title VII.[13] State Farm entered into a settlement agreement stating that payments to class members were being made inclusive of attorneys' fees and costs, to which the class members were entitled as prevailing plaintiffs.[14] The IRS asserted that the attorneys' fees were taxable to the class members, and the courts agreed.

A.H. McKean[15] is a more favorable decision. There, the Court of Federal Claims granted a motion for summary judgment to members of an opt-out class in a Title VII case, permitting them to exclude their *pro rata* share of attorneys' fees from income. In granting the class' motion for summary judgment, the court noted that it was doing so merely because the government failed to challenge the motion.[16]

In *Eirhart,*[17] an action to which the IRS was not a party, the court held that fees paid in an opt-out Title VII case 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 results from cases like the State Farm Cases, which appear not to have been paid through a common fund.

Reconciling the Cases

Despite *Banks* and despite the Jobs Act, this area of the tax law is muddled. Although the tax treatment of attorneys' fees in general remains troublesome, this is especially true for class actions. Most class action plaintiffs do not realize that they could be taxed on their proportionate share of the sometimes enormous attorneys' fees paid to class counsel. For that matter, many class action attorneys are also completely oblivious to this potential.

The Jobs Act and *Banks* significantly impact the taxation of attorneys' fees in class action lawsuits. After the Jobs Act, the Internal Revenue Code now provides that attorneys' fees in employment cases are fully deductible from gross income, meaning there is a 100-percent offset, even for purposes of the AMT. This will make plaintiffs indifferent to whether they must take their share of attorneys' fees into income, since they can now deduct the full amount of any fees they must include.

Arguably, a class member in certain types of lawsuits is much better off now, since federal suits under the ADEA, FLSA and Title VII are treated as opt-in cases, and a plaintiff opting in to such a case previously had a tax problem. Now, these three federal causes of action, like any other federal or state employment claim, will give rise to a 100-percent legal fee deduction. For employment cases, this makes the attorneys' fees a wash.

Unfortunately, the treatment of attorneys' fees in other types of class actions is not so clear. Assuming a non-Jobs Act recovery, a class action involving a small net damage recovery with substantial attorneys' fees may be quite punitive.

> **Example.** A class of 100 plaintiffs in a nonemployment case recovers a $100 million judgment, which includes $80 million of attorneys' fees. Class members are required to recognize their proportionate share of the gross amount, so will collectively be taxed on the entire $100 million recovery. They are entitled to miscellaneous itemized deductions for the amount of the legal fees. Each member of the class owes $276,500 in federal income tax on his proportionate share

> of the recovery (assuming each taxpayer is married filing jointly). Of this amount, over $213,000 stems from the AMT.
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> Each class member actually ends up *losing* $76,500 after taxes as a result of "winning" the case. Each class member is allocated $1 million in gross income, and each class member is allowed to deduct a proportionate share of the attorneys' fees, $800,000. From a cash-flow standpoint, that yields $200,000 in cash. Of course when you chalk up $276,500 in federal income taxes, you end up in the red by $76,500.[18]

In contrast, if each class member is only required to include the net amount of $200,000 in gross income, he will owe $42,297.50 in federal income tax. That yields a whopping $234,202.50 difference. This much more favorable tax liability results if the Jobs Act covers the recovery (an employment case) or if the recovery escapes the general rule stated in *Banks*.

Resolution in *Banks*?

On the surface, the *Banks* case decided by the Supreme Court in early 2005 resolves the split in the circuits, finding that plaintiffs will be taxable on their share of attorneys' fees. The *Banks* case involved the consolidated cases of *Banks* and *Banaitis*, two cases in which the IRS (not the taxpayer) had petitioned the Supreme Court for *certiorari*. Attempting to shy away from reliance on state attorneys' lien law (something upon which the majority of the circuit court cases had relied), the Supreme Court announced the general rule that plaintiffs will have gross income measured by the attorneys' fees paid to their lawyers. The Supreme Court seems strongly influenced by the proposition that the Jobs Act obviated this income inclusion in employment cases (thus covering *Banks* and *Banaitis* had they involved recoveries after the effective date of the Jobs Act).

There is no discussion in *Banks* of the manner in which the general rule announced there would apply to class action attorneys' fees. However, the court does acknowledge that it is not considering many of the issues brought before it, primarily by *amicus* briefs. For example, the Supreme Court says that it is not considering the impact of cases in which injunctive relief is sought by the plaintiff, thus raising the specter of an allocation of attorneys' fees between those pursuing the injunctive relief and those pursuing money damages. This circumstance could obviously arise in a class action.

Much more significantly, the Supreme Court leaves for another day the appropriate tax treatment of cases in which there is a statutory fee award. Interestingly, the court does recognize that the *Banks/Banaitis* facts involved a statutory fee-shifting statute, but the court suggests that this by itself is not sufficient to avoid income to the plaintiff absent one or more of the following: (1) some indication in the contingent fee agreement that the plaintiff's attorney is being compensated for the availability of statutory fees, even if the attorney ends up receiving a contingent fee amount in lieu of a statutory fee award; (2) some indication in the settlement agreement that the plaintiff's attorney is being compensated *via* a statutory fee award, or contingent payment in lieu thereof; or (3) an actual statutory fee award by a court.

Class action attorneys might well read the Supreme Court's reservation on these points as suggesting that the attorneys' fee tax issue will surely be solved to the benefit of taxpayers/plaintiffs in such a case. However, all the Supreme Court does is leave that decision for another day. To my mind, the Supreme Court has outlined a clearly marked path to follow in any case (class action or otherwise) involving a statutory fee shifting statute. First, the Supreme Court suggests that the best of all worlds will be a court award of the attorneys' fees, preferably directed solely at the plaintiff's counsel. This will often be the case in a class action, and if it is, it may not be necessary to go further in the tax analysis.

However, creative plaintiffs' counsel should already be retooling their fee agreements, as well as what might be regarded as the "stock" provisions in their form settlement agreements. The Supreme Court in *Banks* implies (if it does not outright state) that a provision in a contingent fee agreement that recognizes that the claim will be pursued under a statutory fee shifting statute, and that therefore recognizes that the lawyer may in effect be paid by the defendant rather than the plaintiff, may be enough. Presumably, most plaintiffs' counsel will not agree to be compensated solely in this way, and will want to know that either they will receive a court award of attorneys' fees from the defendant, or a contingent fee share from their own client(s).

It should be possible to draft language in the fee agreement that accomplishes both goals, thus leaving the door open for the overriding statutory fee shifting statute, which is in all events deemed to compensate plaintiffs' counsel. The same can be said for the settlement agreement, at which stage it will presumably be clear exactly how the plaintiffs' counsel is being compensated, and from whom.

These drafting niceties may seem like silly savings clauses that will not effect (and hopefully they will not) the real economics of the plaintiffs' counsel arrangement. At the same time, the Supreme Court in *Banks* does suggest that such provisions that may make a difference in determining the ultimate tax burden of the plaintiffs' counsel fees on the plaintiff himself. Considering the potential tax liability, making this attempt seems the best alternative.

Given the realities of class actions, in which the plaintiffs' counsel will presumably be applying to the court for approval of its fees, jumping through these hoops should not be difficult. That leads me to hope that, while *Banks* does not expressly address class action attorneys' fees, it may hold promise for a better result when the next class action attorneys' fee case is litigated. Such feelings of optimism should be tempered, though, with the reality of decisions such as *Sinyard*, in which a class member is tagged with his share of attorneys' fees.

Reconciliation

In attempting to reconcile the different results reached by the various cases, it is again important to distinguish opt-in class actions from opt-out class actions. It is also important to differentiate attorneys' fees in opt-out class actions paid out under the common fund theory of recovery from those not paid out under this common fund theory of recovery. In differentiating opt-in class actions from opt-out class actions, it is helpful to compare the results reached by the court in *Sinyard*,[19] with the results in *Eirhart*.[20]

In *Sinyard*, the court distinguished *Eirhart* on the grounds that it was based on a common fund theory that appears applicable 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. 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. 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, on the other hand, 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 attorneys' fees by opt-in class members generally constitutes gross income to the class members.

Attorneys' fees paid out under a common fund theory are generally not includible in gross income of the opt-out class members. Attorneys' fees recovered by opt-out class members in noncommon fund recoveries are includible in the gross income of opt-out class members. In the case of attorneys' fees paid under a common fund theory of recovery, the attorneys' fees are generally awarded directly to the class counsel based on judicial precedent.[21] 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.[22] This result can be reconciled with the result in noncommon fund opt-out recoveries, in that these plaintiffs generally individually agree to compensate class counsel, and accordingly have income (under a discharge of indebtedness theory) when the attorneys' fees are paid to class counsel.

Conclusions

If the case is an employment case and thus falls within the ambit of the Jobs Act's new deduction for attorneys' fees, the plaintiff is home free. Although the class member may have to take his share of legal fees into income, he gets to deduct it dollar-for-dollar, so suffers no additional tax. If it is not an employment case, the class member must consider the opt-in opt-out gauntlet. This means usually (though not exclusively) that a plaintiff will have to worry if he is a class member who has opted in to a case.

Of course, against this general background, consider the impact of statutory fee awards, the potentially huge exception sidestepped by the Supreme Court in *Banks*. Although I've offered suggestions here for how one might try to fall within the Supreme Court's apparent statutory fee award carve-out, this remains uncertain.

This, then, brings us to other ways in which we might ameliorate these tax issues. Where possible, make sure that separate 1099s are issued to class counsel and to the plaintiffs. Also, from a tax perspective, class members are better off not signing the fee agreement with class counsel, though class counsel will hardly be happy with this advice, nor with taking this notion to extremes.

As to the award of attorneys' fees, if at all possible, 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.

ENDNOTES

[1] *J.W. Banks,* SCt, 2005-1 USTC ¶50,155, 125 SCt 826.

[2] *See* Robert W. Wood, *Supreme Court Attorney Fees Decision Leaves Much Unresolved,* 2005 TNT 24-67 (Feb. 7, 2005),TAX NOTES, Vol. 106, No. 7, Feb. 14, 2005, at 792.

[3] American Jobs Creation Act of 2004 (P.L. 108-357).

[4] *See* Robert W. Wood, *Jobs Act Attorney Fee Provision: Is It Enough?* 2004 TNT 215-27 (Nov. 5, 2004), TAX NOTES, Vol. 105, No. 8, Nov. 15, 2004, at 961.

[5] *See* Robert W. Wood, *Effective Date of Attorney Fee Deduction Misses Many Judgments,* 2004 TNT 240-19, Dec. 14, 2004, TAX NOTES, Vol. 105, No. 13, Dec. 20, 2004, at 1,643.

[6] *J.T. Sinyard,* CA-9, 2001-2 USTC ¶50,645, 268 F3d 756, 81 EMPL. PRAC. DEC. (CCH) ¶40,747, *aff'g,* 76 TCM 654, Dec. 52,910(M), TC Memo. 1998-364, *cert. denied,* 536 US 904 (2002).

[7] *Eirhart v. Libbey-Owens-Ford Co.,* DC Ill., 90-2 USTC ¶50,337, 726 FSupp 700, *aff'd,* CA-7, 996 F2d 837, 62 EMPL. PRAC. DEC. (CCH) ¶42558 (1993) (discussed below).

[8] *See B.D. Nelson,* T.C. Summary Opinion 2001-44 (Apr. 2, 2001); *K.W. Hamblin,* 2001 Tax Ct. Memo LEXIS 147 (May 21, 2001); *M.R. Fawcett,* T.C. Summary Opinion 2001-65 (May 2, 2001); *R.W. Waters,* T.C. Summary Opinion 2001-46 (Apr. 3, 2001). Under Code Sec. 7463(b), Tax Court Summary Opinions may not be treated as precedent.

[9] *Nelson, id.*

[10] *E.R. Kenseth,* CA-7, 2001-2 USTC ¶50,570, 259 F3d 881.

[11] LTR 200222001 (Feb. 28, 2002); LTR 200316040 (Feb. 28, 2003); LTR 200106021 (Nov. 7, 2000); LTR 200025023 (Mar. 22, 2000). Of course, under Code Sec. 6110(k)(3), private letter rulings may not be used or cited as precedent, but they can be very helpful in deducing the IRS's current position with respect to particular tax matters.

[12] Rev. Rul. 80-364, 1980-2 CB 294 (Situation 3).

[13] *T. Miller,* 81 TCM 1258, Dec. 54,266(M), TC Memo. 2001-55; *W.J. Westmiller,* 75 TCM 2144, Dec. 52,659(M), TC Memo. 1998-140; *E.W. Reiher,* 75 TCM 1848, Dec. 52,586(M), TC Memo. 1998-75; *W.R. Easter,* 75 TCM 154, Dec. 52,509(M), TC Memo. 1998-8; *C.D. Brewer,* 74 TCM 1337, Dec. 52,387(M), TC Memo. 1997-542, *aff'd,* 99-1 USTC ¶50,378, 172 F3d 875; *F. Gillette,* 73 TCM 3235, Dec. 52,128(M), TC Memo. 1997-30; *T.J. Hayes,* 73 TCM 2734, Dec. 52,032(M), TC Memo. 1997-213; *N.S. Hardin,* 73 TCM 2693, Dec. 52,021(M), TC Memo. 1997-202; *J.P. Raney,* 73 TCM 2687, Dec. 52,019(M), TC Memo. 1997-200; *D.E. Clark,* 73 TCM 2466, Dec. 51,968(M), TC Memo. 1997-156; *J.L. Berst,* 73 TCM 2338, Dec. 51,945(M), TC Memo. 1997-137; *R. Martinez,* 73 TCM 2289, Dec. 51,934(M), TC Memo. 1997-126, *aff'd,* 99-1 USTC ¶50,168, 166 F3d 343; *L.E. Frederickson,* 73 TCM 2287, Dec. 51,933(M), TC Memo. 1997-125, *aff'd,* 99-1 USTC ¶50,167, 166 F3d 342 (collectively the "State Farm Cases").

[14] *See e.g., N.S. Hardin, id.,* 73 TCM 2693, 2697 (1997).

[15] *A.H. McKean,* FedCl, 95-2 USTC ¶50,382, 33 FedCl 535.

[16] *Id.,* at 539.

[17] *Supra* note 7.

[18] This example may seem far-fetched, but it is not. *See Spina v. Forest Preserve Dist. Cook County,* DC Ill., 207 FSupp2d 764 (2002) (where a Chicago police officer won a sex discrimination suit, only to find that she had to *pay* $99,000 more in taxes than she won in her lawsuit).

[19] *Supra* note 6.

[20] *Supra* note 7.

[21] Under the common fund theory of recovery, class counsel may petition the court directly for attorneys' fees. *See, e.g., Boeing v. Van Gemert,* SCt, 444 US 472, 478, 100 SCt 745, FED. SEC. L. REP. (CCH) ¶97,279 (1980).

[22] *See e.g.,* LTR 200222001 (Feb. 28, 2002); LTR 200316040 (Feb. 28, 2003); LTR 200106021 (Nov. 7, 2000); LTR 200025023 (Mar. 22, 2000).