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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:ITA:4 – PLR-165792-02

Date:

July 01 2003

LEGEND:

Fund =
Defendants =

Plaintiffs =

Court B =
\$Y =
\$Z =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =

Dear :

This letter responds to your request for a letter ruling regarding the reporting obligation of the Fund with respect to the payments to class counsel made pursuant to a settlement agreement and court order regarding attorneys' fees. Specifically, you request the following rulings:

(1) The amounts paid to class counsel as attorneys' fees pursuant to the court order are not income to the class members under § 61 of the Internal Revenue Code, and therefore are not subject to information reporting to the class members §§ 468B or 6041.

(2) The amounts paid to class counsel as attorneys' fees pursuant to the court order are income to the attorneys and should be reported on a Form 1099 under § 6045(f).

FACTS

Based on the facts and representations made in connection with the ruling request, the Fund is a qualified settlement fund as defined in § 468B. The Fund is organized under the jurisdiction of Court B and was formed to administer a settlement agreement of a

lawsuit arising from allegations of unlawful compensation practices.

The Plaintiffs claimed that the Defendants violated the Fair Labor Standards Act and various state Labor Laws. The Plaintiffs alleged that Defendants failed to compute overtime rates properly and failed to pay overtime premiums for hours worked during meal and rest breaks and for working over 8 hours a day. The Plaintiffs asked for back pay, liquidated damages, penalties, interest, attorneys' fees, and costs. The union representing the collective-bargaining employees filed a written grievance with the Defendants, alleging violation of the applicable bargaining agreement in that the Defendants did not compensate bargaining unit employees for missed meal and rest breaks.

On Date 1, Court B certified the Plaintiffs as a class. The class action was an "opt-out" class action. Prior to class certification, plaintiffs signed contingency fee agreements with class counsel, providing for a 33 percent contingency fee.

After arm's length negotiations and mediation, the parties entered into a settlement agreement to resolve the claims of the lawsuit. Pursuant to the settlement agreement, the Defendants paid \$Y to settle the lawsuit. The settlement amount was to be used to pay or satisfy the following: (1) claims of the settlement class; (2) claims for Plaintiffs' expenses; (3) claims for Plaintiffs' attorneys' fees; (4) enhancements to class representatives; (5) payroll taxes, including Defendants' share of Federal Insurance Contribution Act taxes on the wage payments made to the claimants'; and (6) the grievance filed by the union.

On Date 2, Court B granted an order granting preliminary approval of the settlement. In that approval, the court ordered that notices be sent to eligible class members. The court also set Date 3 as the deadline for objections and requests for exclusion from the class. After this opt-out/objection process was completed, the class was composed of class members.

On Date 4, under the equitable common fund doctrine, Court B awarded attorneys' fees to the class counsel in the amount of 20 percent of the settlement amount. Once the class was certified, the court acquired authority over the award of attorneys' fees. The court disregarded the contingency fee that the attorneys would have been entitled to under their separate retainer agreements with individual members of the class had the action proceeded without class certification. Later that month, the court granted final approval of the settlement agreement. On Date 5, disbursements were made to class members and class counsel.

LAW & ANALYSIS

Gross Income Defined

Section 61 provides generally that, except as otherwise provided by law, gross income

includes all income from whatever source derived. The concept of gross income encompasses accessions to wealth, clearly realized, over which taxpayers have complete dominion. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); 1955-1 C.B. 207.

In Rev. Rul. 80-364, 1980-2 C.B. 294 (situation 3) a union filed claims on behalf of its members against a company due to a breach of a collective bargaining agreement. Subsequently, the union and the company entered into a settlement agreement, later approved by a federal district court, that provided that the company would pay the union 40x dollars in full settlement of all claims. The union paid 6x dollars of the settlement for attorneys fees and returned 34x dollars to the employees for back pay owed to them. The ruling concluded that the portion of the settlement paid by union for attorney's fees was a reimbursement for expenses incurred by the union and not includible in the gross income of the union members.

Payments made to class counsel in this opt-out class action are not income to the class members. This result is similar to the result in situation 3 of Rev. Rul. 80-364, 1980-2 C.B. 294. In opt-out class actions, a class member obtains the benefits of an opt-out class action merely by coming within the definition of the class, unless the member affirmatively excludes himself from the lawsuit. Our conclusion that the payments made to class counsel are not income to the class members is specific to the facts of this case. See *Cf. Sinyard v. Commissioner*, T.C.M. 1998-264, *aff'd*, 268 F.3d 756 (9th Cir. 2001), *cert. denied sub nom, Sinyard v. Rossotti*, 122 S.Ct. 2357 (2002), *Fredrickson v. Commissioner*, T.C. Memo 1997-125, *aff'd* in unpub. opinion, 97-71051 (9th Cir. 1998).

Information Reporting Requirements

Section 1.468B-2(l)(2)(i) of the Income Tax Regulations provides that, in general, payments and distributions by a qualified settlement fund (QSF) are subject to certain information reporting requirements and withholding requirements. Section 1.468B-2(l)(2)(ii) provides that a QSF must make a return for, or must withhold tax on, a distribution to a claimant if one or more transferors would have been required to make a return or withhold tax had that transferor made the distribution directly to the claimant. The regulations further provide that, for purposes of §§ 6041(a) and 6041A, if a QSF makes a payment or distribution on behalf of a transferor or a claimant, the fund is deemed to make the payment or distribution to the recipient of that payment or distribution in the course of a trade or business. In such situation, the QSF is also deemed to have made the distribution or payment to the transferor or claimant.

Section 6041 requires all persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income of \$600 or more in any taxable year, to file an information return with the Service and to furnish an information statement to the

payee.

Section 1.6041-1(c) provides that payments are fixed when they are paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. Section 1.6041-1(a)(2) requires a payor to report § 6041 amounts on Form 1099.

Section 6045(f) requires any person engaged in a trade or business and making a payment (in the course of such trade or business) to an attorney to file a information return with the Service and to furnish an information statement to the attorney. Section 6045(f) applies to any payment to an attorney in connection with legal services (whether or not such services are performed for the payor). However, § 6045(f)(2)(B) provides that § 6045(f) does not apply to the portion of any payment that is required to be reported under § 6041(a) (or would be so required but for the dollar limitation contained therein) or § 6051.

The Fund is not required to report attorneys' fees to class members because the attorneys' fees paid do not constitute gross income to the class members. The Fund is required to report the attorneys' fees to the class counsel. The Fund is making the payments to the attorneys on behalf of the class members and is treated as making the payment in the course of its trade or business. See § 1.468B-2(l)(2)(ii)(C). The attorneys' fees are fixed or determinable income reportable under § 6041. Because the Fund is required to report the attorneys' fees to the class counsel under § 6041(a), the Fund is not required to report the attorneys' fees under § 6045(f).

CONCLUSIONS

Based on the facts and information submitted and the representations made, the following rulings are issued:

- (1) The amounts paid to class counsel as attorneys' fees are not income to the class members under § 61. Because the attorneys' fees paid by the Fund to the class counsel do not constitute gross income to the class members, the Fund is not required to report the attorneys' fees to the class members.
- (2) The Fund is required to report the attorneys' fees to the class counsel under § 6041.

CAVEATS:

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110.

Except as expressly provided herein, no opinion is expressed or implied concerning the

tax consequences of any aspect of any item discussed or referenced in this letter. This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Robert A. Berkovsky
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosures (2)