

Internal Revenue Service

Department of the Treasury

Number: **200344022**
Release Date: 10/31/2003
Index No.: 61.00-00
 3405.00-00
 6041.03-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:ITA:4 – PLR-106149-03

Date:

July 24, 2003

LEGEND:

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

Dear _____ :

This letter is in response to your ruling request regarding the tax treatment of attorneys' fees paid by B in connection with the settlement of a class action lawsuit. Specifically, you request the following two rulings:

- (1) The attorneys' fees paid from the settlement fund to class counsel are not includible in the gross income of the Class Members.

- (2) No person is required to withhold federal income tax from the payments made to the Class Members from the settlement fund on account of the payment of the attorneys' fees, nor is any person required to issue or file information returns reporting the payment of any portion of the attorneys' fees as taxable income to any Class Member.

PLR-106149-03

FACTS

On Date 1, a plaintiff filed a class action lawsuit against B, alleging that B had miscalculated the amounts of lump-sum distributions made to participants (and their beneficiaries) in violation of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). The lawsuit sought recovery of additional pension benefits from B to be payable to a class of plaintiffs comprised of all participants and their beneficiaries who had received lump-sum distributions from B at any time after Date 2 (“Class Members”).

On Date 3, the parties entered into a settlement agreement resolving all claims brought in the litigation. On that same date, the court granted preliminary approval to the terms of the settlement and granted conditional certification of a “settlement class” comprised of the Class Members pursuant to Rules 23(b)(1) and (2) of the Federal Rules of Civil Procedure. Pursuant to these rules, an individual who falls within the definition of a Class Member automatically becomes a member of the class and is entitled to the benefits of the settlement. No Class Member has a right to exclude himself or herself from the class action lawsuit.

The settlement agreement created a settlement fund of \$X funded from the assets of B. Under the settlement agreement, each Class Member is entitled to receive a base payment of \$Y, plus a proportional share of the “net settlement fund.” The “net settlement fund” is defined as the “settlement fund less the total base payments and the amount awarded by the court for attorneys’ fees, administrative expenses and costs.”

Following the court’s order granting preliminary approval, the class counsel sent notice of the terms of the settlement agreement to all Class Members. The notice advised the Class Members of the terms of the proposed settlement and that the court had set a date for a hearing on the fairness of the proposed settlement. The notice further advised that all Class Members would be bound by the terms of the settlement agreement as finally approved by the court and no Class Member had the right to be excluded from the lawsuit. No individual Class Member personally entered into a fee agreement with the class counsel.

On Date 4, the court granted final approval of the settlement agreement and awarded the class counsel \$Z from the settlement fund for attorneys’ fees, administrative expenses, and costs. The judgment and final approval of the settlement agreement became a final judgment on Date 5. The settlement agreement provided that B shall pay attorneys’ fees directly to the class counsel.

PLR-106149-03

Pursuant to the settlement agreement, a Class Member is entitled to participate in the settlement only if the Class Member is a plan participant and (1) the person is identified by class counsel and the defendant as a confirmed Class Member, or (2) the person meets certain other requirements and is confirmed to be a Class Member by class counsel and B's counsel based on a claim submitted by that person by the 90th day following the date of final judgment. Thus, as of the date of final judgment, the identity of all the individual Class Members and the quantification of their claims were not known.

LAW

Section 61 of the Internal Revenue Code 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.

Situation 3 of Rev. Rul. 80-364, 1980-2 C.B. 294 concluded that, with respect to the settlement of a lawsuit brought by a union against an employer to enforce a collective bargaining agreement, a portion of the settlement paid by the union for attorneys' fees was a reimbursement for expenses incurred by the union and not includible in the gross income of the individual union members.

Section 3405(e)(1)(B) provides that the term "designated distribution" means any distribution or payment from or under (i) an employer deferred compensation plan, (ii) an individual retirement plan (as defined in § 7701(a)(37)), or (iii) a commercial annuity, except the portion of a distribution or payment that it is reasonable to believe is not includible in gross income.

Section 1.468B-2(l)(2)(i) of the Income Tax Regulations generally provides that payments and distributions by a qualified settlement fund (QSF) are subject to the information reporting requirements of part III of subchapter A of chapter 61 of the Internal Revenue Code and the withholding requirements of subchapter A of chapter 3 of subtitle A and subtitle C.

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. For purposes of § 6041(a), 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

PLR-106149-03

business.

Section 6041(a) provides in part that 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, shall render a true and accurate return to the Secretary. Section 6041(d) provides that every person required to make a return under subsection (a) shall furnish to each person with respect to whom such a return is required a written statement. The written statement must show the name, address, and telephone number of the information contact of the person required to make such return, and the aggregate amount of payments to the person required to be shown on the return.

Section 1.6041-1(2)(b) explain that "persons engaged in trade or business" includes not only those so engaged for gain or profit, but also organizations the activities of which are not for the purpose of gain or profit, including organizations referred to in § 401(a) of the Code. Therefore, B is a person engaged in trade or business within § 6041.

Section 6041 requires the reporting of all compensation or other fixed or determinable gains, profits, and income. The word income as used in § 6041 is not defined by statute or regulation; however, its appearance in the phrase fixed or determinable gains, profits, and income indicates that what is referred to is gross income, and not the gross amount paid. Thus, § 6041 requires the settlement fund to report only those payments includible in the Class Members' gross income.

ANALYSIS

The attorneys' fees awarded to class counsel from the settlement fund are not includible in the gross income of the Class Members in this class action, in which the members do not have any express contractual relationship with class counsel and who were not even identified until after final judgment. This conclusion is similar to Rev. Rul. 80-364, 1980-2 C.B. 294, situation 3, involving the settlement of a lawsuit brought by a union against an employer to enforce a collective bargaining agreement. Class actions are employed by the judicial system to consolidate in one lawsuit a group of common claims against the same defendant. Class actions frequently come about as representative litigation in which the claims of a great many similarly interested individuals are pursued by the class representatives. Under the class action at issue, a Class Member obtains the benefits of the settlement by merely coming within the definition of the class. Our conclusion that the attorneys' fees awarded to class counsel are excluded from the gross income of Class Members is specific to the facts of this case. *Cf. Sinyard v. Commissioner*, T.C.M. 1998-364, *aff'd*, 268 F.3d 756 (9th Cir.

PLR-106149-03

2001), *cert. denied sub nom, Sinyard v. Rossotti*, 122 S.Ct. 2357 (2002) (fees awarded under the ADEA); *Fredrickson v. Commissioner*, T.C. Memo 1997-125, *aff'd in unpub. opinion*, 97-71051 (9th Cir. 1998) (settlement of mandatory, Title VII class action in which class members personally signed settlement agreements providing for compensation of counsel).

Because the attorneys' fees do not constitute gross income to the Class Members, the attorneys' fees are not part of the "designated distribution" and thus are not subject to mandatory withholding under § 3405(c)(1)(B).

Because income under § 6041 is interpreted to mean only income includible in gross income under § 61, the payments of any portion of the attorney fees are not required to be reported as taxable income to any Class Member under § 6041. Therefore, no person is subject to the reporting requirements of § 6041 with respect to such portion of the payments.

CONCLUSION

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

- (1) Payments made to class counsel from the settlement fund are not includible in the Class Members' gross income under § 61.
- (2) Because the attorneys' fees do not constitute gross income to the Class Members, the attorneys' fees are not part of the "designated distribution" and thus are not subject to mandatory withholding under § 3405(c)(1)(B). Thus, no person is required to report payments made to class counsel for attorneys' fees under § 6041.

CAVEATS:

A copy of this letter must be attached to any income tax return to which it is relevant.

PLR-106149-03

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)