

## INTERNAL REVENUE BULLETIN

The following items are from Internal Revenue Bulletin No. 1987-2, dated Jan. 12, 1987. The summaries of revenue rulings, revenue procedures, notices, and other announcements are followed by their full texts, except for items that because of their unusual length can only be run in partial text. The full texts of these items can be purchased from BNA PLUS toll-free (800) 452-7773 nationwide; (202) 452-4323 in Washington, D. C.

Revenue rulings represent the conclusions of the IRS on the application of the law to the stated facts. They apply retroactively unless otherwise indicated. Revenue procedures are published in the Bulletin if they affect the rights and duties of taxpayers, but not if they relate solely to matters of internal management. Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents.

### SEC. 61—GROSS INCOME

• *Lawyer Trust Account Fund created, supervised, and controlled by a state Supreme Court is not subject to federal income tax, and interest income on lawyers' pooled account for clients' nominal and short-term advances is not taxable.* REV. RUL. 87-2

**Facts:** Lawyers in a certain state are required to deposit clients' funds in a trust account. Because advances from clients are often small and are to be held by the lawyers for only a brief period of time, the long-standing practice of lawyers was to deposit these advances in a commingled checking account. These commingled accounts did not bear interest because fiduciary rules prohibit a lawyer from receiving interest on client trust funds.

Pursuant to its authority to regulate the practice of law, the Supreme Court of the state established a Lawyer Trust Account Fund. Under the state Supreme Court's order, client funds received by lawyers are to be deposited into interest-bearing accounts. All funds received from clients that are of nominal amount and are to be held by the lawyer for only a short period are to be deposited into a pooled account, the interest on which is payable to the fund. If the client funds are either of more than a nominal amount or are to be held for a long period of time, the funds must be deposited into an account the interest on which is payable to the client.

The fund invests the interest received from lawyers' pooled accounts and disburses it for public purposes. The fund is governed by nine members—six lawyers and three public members. The public members and three of the lawyers are appointed by the Supreme Court. The remaining three lawyers are nominated by the bar association of the state, but the Supreme Court may decline to appoint them. The Supreme Court may remove any member of the fund's governing body, with or without cause. The fund is required to submit quarterly reports to the Supreme Court, and one of the Supreme Court's judges attends all the fund's meetings. The Supreme Court may override the fund's decisions relating to investment and disbursement of its assets. The fund is staffed by employees of the Supreme Court.

If the Supreme Court decides to abolish the fund, any assets then on hand will be transferred, as directed by the Supreme Court, to a successor state agency, to an exempt charitable organization, or to the general fund of the state.

**Holding:** (1) The fund's income is not subject to federal income tax. The Supreme Court's creation of the fund and its ability to select and remove the fund's governing body, to control the fund's investments and expenditures, to monitor the fund's daily operation, and to abolish the fund indicate that the fund is not an independent entity, but rather is an integral part of the state.

(2) Interest income that is earned on certain pooled accounts containing client nominal and short-term funds and paid over to the fund pursuant to the order of the Supreme Court is not includable in the gross income of either the clients or lawyers. Neither the clients nor the lawyers have control over, or right to, such interest.

### Full Text ISSUES

1. If, under the circumstances described below, a Lawyer Trust Account Fund (Fund) is created by an order of a state Supreme Court and operates under the court's supervision and ongoing control, is the Fund subject to federal income tax?

2. If interest income that is earned on certain pooled accounts containing client funds held by lawyers is paid over to the Fund, is that interest includable in the gross incomes of either the clients or lawyers?

### FACTS

Lawyers in state A are required to place in a trust account funds received from clients to be used for those clients, as when a client deposits an amount with a lawyer for payment of court costs in the client's case. In many cases these advances are too small and are on deposit for too short a time to permit, as a practical matter, their deposit in separate accounts for each client or their deposit in a commingled interest-bearing account with interest allocated to each client. As a consequence, the long-standing practice of lawyers in the state was to deposit these small and short-term advances in a commingled checking account. These commingled accounts did not bear interest because fiduciary rules prohibit a lawyer from receiving interest on client trust funds.

In response to this situation and, in particular, to avoid the necessity for using noninterest-bearing accounts, the Supreme Court of the state, pursuant to its authority to regulate the practice of law, issued an order establishing the Fund and promulgating rules for the Fund's operations and financial support.

The order requires that client funds received by lawyers be deposited into interest-bearing accounts. If the client funds are of nominal amount and are to be held by the lawyer for only a short period, then the funds are required to be deposited into a pooled account containing similar funds received from other clients, the interest on which is payable to the Fund. The client cannot compel the lawyer to invest the funds on the client's behalf. In cases where the client funds are either of more than a nominal amount or are to be held for a long period of time, the funds must be deposited into an account the interest on which is payable to the client.

Interest paid over to the Fund from the pooled accounts is invested and is disbursed by the Fund for public purposes, as determined by the Fund. The Fund is governed by nine members—six lawyers having their principal offices in the state and three public members, who are residents of the state. The public members and three of the lawyers are directly appointed by the Supreme Court. The remaining three lawyers are nominated by the bar association of the state, a professional organization exempt from federal income tax under section 501(c)(6) of the Internal Revenue Code. The Supreme Court may decline to appoint the bar association's nominees and may appoint other persons instead. Further, the Supreme Court may remove any member of the governing body of the Fund at any time, with or without cause. The Fund is required to maintain adequate books and records and to

make formal reports to the Supreme Court on a quarterly basis. The Supreme Court monitors the activities of the Fund by having one of its judges attend all meetings of the Fund (subject to absences due to scheduling conflicts). The judge who attends Fund meetings reports regularly to the Court regarding Fund matters.

The members of the Fund meet monthly to determine how to invest and disburse the assets of the Fund. The Supreme Court retains the right, however, to override decisions of the members regarding investments and disbursements. The Fund has no employees of its own and its daily operations are conducted by Supreme Court employees acting as such.

The Fund may be abolished by order of the Supreme Court. If the Fund's operations are discontinued, any funds then on hand will be transferred, as directed by the Supreme Court, to a successor state agency, to an organization exempt from income tax under section 501(c)(3) of the Code, or to the general fund of the state.

#### LAW AND ANALYSIS

Under section 61 of the Internal Revenue Code gross income means all income from whatever source derived, except as otherwise provided.

Income earned by a state, a political subdivision of a state, or an integral part of a state or political subdivision of a state is generally not taxable in the absence of specific statutory authorization for taxing such income. See Rev. Rul. 71-131, 1971-1 C.B. 28, and Rev. Rul. 71-132, 1971-1 C.B. 29, holding that income derived from the operation of liquor stores by a state is not subject to federal income tax. An example of a statutory exception to this general rule is found in section 511(a)(2)(B) of the Code, under which the unrelated business taxable income of colleges and universities that are state agencies or instrumentalities is taxable.

In this case, the Supreme Court's creation of the Fund and its ability to select and remove the Fund's governing body, to control the Fund's investments and expenditures, to monitor the Fund's daily operation, and to abolish the Fund indicate that the Fund is not an independent entity, but rather is an integral part of the state. Therefore, income earned by the Fund is not subject to federal income tax.

Rev. Rul. 81-209, 1981-2 C.B. 16, considered a lawyer trust account arrangement similar to the one in this ruling. In Rev. Rul. 81-209, interest earned on clients' nominal and short-term advances that were deposited in a lawyer's trust account was paid over to a bar foundation pursuant to a program established by the Supreme Court of State. The bar foundation was a nonprofit charitable organization as described in section 501(c)(3) of the Code. The program barred clients from receiving the benefit of any interest earned on the deposited advances. Further, clients could not compel the attorney to invest the advances for the clients' benefit. The ruling held that, under the unique facts of the arrangement, interest earned on clients' nominal and short-term advances and paid over to a charitable organization is not includible in the gross incomes of the clients.

Similarly, in this case, the clients and lawyers have no right to the interest earned on the client accounts that is required by the Supreme Court order to be paid over to the Fund. Consequently, because neither the clients nor the lawyers have control over, or right to, such interest, the interest paid over to the Fund is not taxable to either the clients or lawyers. The interest is included in the Fund's income.

#### HOLDINGS

(1) The Fund's income is not subject to federal income tax since the Fund is an integral part of the state.

(2) Interest income that is earned on certain pooled accounts containing client nominal and short-term funds and paid over to the Fund pursuant to the order of the Supreme Court is not includible in the gross incomes of either the clients or lawyers.

#### EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 81-209, 1981-2 C.B. 16, is amplified.

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