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Person to Contact:

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Date:
December 3, 1998

In re:

Legend:

State =
Client =
Foundation =
Law Firm =
Financial Institution =
Rule =

Dear :

This is in response to your request for rulings concerning the Interest on Lawyer Trust Account (IOLTA) program of State. This ruling request was submitted on behalf of the Foundation, Client, Law Firm, and the Financial Institution. The relevant facts are summarized below.

Lawyers in State who are retained to render legal services must place in trust accounts funds received in the ordinary course of their business that belong to clients. In many cases these advances are too small in amount or are on deposit for too short a time to permit, as a practical matter, deposit of the funds in separate accounts for each client or deposit in a commingled account with interest allocated to each client. As a consequence, the longstanding practice of attorneys in State is to deposit these small or short-term advances in commingled, non-interest-bearing trust accounts.

The Supreme Court of State has amended Rule, which governs the safekeeping of client property by lawyers, by authorizing attorneys to commingle the nominal or short-term funds of clients in interest-bearing IOLTA trust accounts instead of non-interest-bearing trust accounts. Generally attorneys are required to establish IOLTA trust accounts unless they elect out of the IOLTA program or under certain circumstances provided in Rule. Interest earned on IOLTA trust accounts is paid to the Foundation, which uses these amounts to fund legal services for the poor and to provide other public programs specifically approved by the Supreme Court of State.

An IOLTA trust account may be established only with authorized financial institutions, such as the Financial Institution. Participating lawyers and law firms must direct the financial institution to remit all interest or dividends, net of reasonable service charges or fees, at least quarterly to the Foundation. Any reasonable service charge that exceeds the interest earned on an IOLTA account during a reporting period must be waived by the financial institution or, alternatively, such excess charge is to be billed to the Foundation.

The IOLTA trust account must include all client funds that are nominal in amount or are to be held for a short period of time. No client may individually elect whether to participate in the program. The funds must be subject to withdrawal upon request and without delay and without risk to principal by reason of such withdrawal.

The IOLTA program specifically bars clients and lawyers or law firms from receiving the benefit of any interest earned on the commingled client funds in the IOLTA accounts. It provides that no earnings from an IOLTA account will be made available to a lawyer or law firm and that such earnings must be remitted by the financial institution to the Foundation. Furthermore, clients cannot compel attorneys to invest the nominal or short-term client funds on the clients' behalf.

It is represented that the purposes of the IOLTA program of State are exclusively charitable and educational exempt purposes and do not serve any substantial non-exempt purpose, such as the promotion, protection, or enhancement of the legal profession, and that the Foundation is an organization described in § 501(c)(3) of the Internal Revenue Code and exempt from federal income tax under § 501(a).

The Financial Institution and Law Firm will participate in the IOLTA program of State. You have requested a ruling that interest earned on Client's nominal or short term funds deposited in Law Firm's IOLTA trust account at the Financial Institution and paid to the Foundation is not includible in the income of Client or Law Firm. In addition, you have requested a ruling that neither Law Firm nor the Financial Institution is required to report interest paid on an IOLTA trust account on Form 1099.

Section 61(a)(4) and § 1.61-7 of the Income Tax Regulations provide that, unless excluded by law, gross income means all income from whatever source derived, including interest. In Commissioner v. Glenshaw Glass Co., 348 U.S. 429 (1955), 1955-1 C.B. 207, the Supreme Court of the United States defined income to include all accessions to wealth that are clearly realized and over which taxpayers have complete dominion.

Rev. Rul. 81-209, 1981-2 C.B. 16, deals with the income tax consequences to the clients in a state IOLTA program similar to the IOLTA program of State. The long-standing practice of attorneys in the state had been to deposit clients' nominal and short-term advances in a lawyer's trust account, which was non-interest-bearing. The state supreme court found that for practical reasons interest could not be made available to the clients on advances that were nominal and held for short duration. However, the court concluded that such funds could be productive of income for charitable purposes. The court established a program whereby an attorney could elect to commingle the nominal and short-term advances of all clients in an interest-bearing trust account instead of a non-interest-bearing account. Interest earned on these trust accounts was paid over to the bar foundation of the state, a nonprofit charitable organization as described in § 501(c)(3). The rights of the clients with respect to these advances were not changed by the program. The program barred clients from receiving the benefit of any interest earned on the advances deposited in an IOLTA trust account. Further, clients could not compel the attorney to invest the advances for the clients' benefit and had no voice in their lawyer's decision to participate in the program. The program authorized, but did not require, lawyers to place nominal and short-term funds into IOLTA trust accounts. No client could elect or veto participation.

Rev. Rul. 81-209 holds that, under the facts of the arrangement, interest earned on clients' nominal and short-term advances and paid over to the foundation is not includible in the gross incomes of the clients.

Rev. Rul. 81-209 was amplified by Rev. Rul. 87-2, 1987-1 C.B. 18, which considers another lawyer trust account arrangement. The supreme court of the state issued an order establishing a Lawyer Trust Account Fund (Fund) and promulgated rules for its operation. The order required that client funds received by lawyers be deposited into interest-bearing accounts. If the client funds were of nominal amount and were to be held by the lawyer for only a short period, then the client funds were required to be deposited into a pooled account containing similar funds received from

other clients, the interest on which was payable to the Fund. Interest paid over to the Fund from the pooled accounts was invested and disbursed by the Fund for public purposes, as determined by the Fund, which was an integral part of the state. The program barred clients from receiving the benefit of any interest earned on these pooled accounts. Fiduciary rules prohibited lawyers from receiving interest on client trust funds.

Rev. Rul. 87-2 holds that because neither the clients nor the lawyers have control over, or right to, interest on pooled accounts paid over to the Fund, the interest paid over to the Fund is not taxable to either the clients or lawyers.

Here, under the IOLTA program of State, Law Firm does not have control over, or right to, interest on the IOLTA trust account paid over to the Foundation. Rule requires Law Firm to segregate Client's funds from its own funds and specifically bars Law Firm from receiving the benefit of any interest earned on the IOLTA trust account. Similarly, Client does not have control over, or right to, interest on the IOLTA trust account paid over to the Foundation.[1] Client cannot elect or veto participation. The Financial Institution must pay all interest earned on an IOLTA trust account, net of any service charges, to the Foundation.

Section 6049(a) provides that every person ("payor") who makes payments of interest (as defined in § 6049(b)) aggregating $10 or more to any other person ("payee") during a calendar year must make an information return setting forth the aggregate amount of such payments, and the name and address of the payee. Form 1099-INT, Statement for Recipients of Interest Income, is required with respect to such payments. Generally, such returns must be filed on magnetic media under § 6011(e)(2).

Section 6049(c) provides that every person required to make a return under subsection (a) shall furnish the payee a written statement (payee statement) showing the aggregate amount of such payments and the name and address of the person required to make such return. A payee statement is a paper statement of the information reported on a Form 1099.

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[1]In Phillips v. Washington Legal Foundation, ___ U.S. ___, 118 S. Ct. 1925 (1998), the Supreme Court of the United States held that interest earned on client funds held in IOLTA accounts is the "private property" of the client for purposes of the Takings Clause (U.S. Const. amend. V). However, the Court left for consideration on remand the question whether IOLTA funds have been "taken" by the state, as well as the amount of "just compensation," if any, due to the clients. Thus, the Court did not hold that the client had any control over, or right to, interest on the IOLTA trust account.

For purposes of § 6049, the term "interest" does not refer to all sums paid for the use of money. Instead, § 6049(b) defines the types of interest reportable under that section. For example, the term "interest" includes interest on deposits with persons carrying on the banking business, but does not include these same payments if the payee is an exempt recipient, except to the extent otherwise provided in regulations.

Pursuant to § 6049(b)(4)(B) and § 1.6049-4(c)(1)(ii)(B), generally a payment of interest to an organization exempt from taxation under § 501(a) is not subject to information reporting. However, § 1.6049-4(c)(1)(i), as in effect before January 1, 1999, provides that a person who withholds tax under § 3451 is required to make an information return regardless of whether the payee is an exempt recipient. But § 3451, which required mandatory withholding on payments of interest, was repealed by the Interest and Dividend Tax Compliance Act of 1983, 1983-2 C.B. 352. In its place, an expanded backup withholding provision was added by Congress.

Backup withholding is required under § 3406. Under this section, a payor must deduct and withhold a tax equal to 31 percent of any reportable interest payment if: (1) the payee fails to furnish a taxpayer identification number (TIN) in the manner required; (2) the Service notifies the payor that the TIN furnished by the payee is incorrect; (3) the Service notifies the payor that there has been a notified payee underreporting; or (4) the payee fails to certify that the payee is not subject to backup withholding.

To be subject to backup withholding, a payment must be "reportable payment" as that term is defined in § 3406(b). A reportable interest payment includes any interest payment required to be shown on an information return under § 6049(a).

Some payees are exempt from backup withholding. Section 3406(g)(1) exempts any organization described in § 6049(b)(4)(B), relating to any organization exempt from taxation under § 501(a). However, backup withholding may be imposed due to a payor error or the failure of an exempt recipient to provide an exemption certificate, if required. An exempt payee may furnish an exemption certificate to the payor to avoid possible erroneous backup withholding. A Form W-9, Request for Taxpayer Identification Number and Certification, may be used for this purpose.

Under Q & A 29 of § 35a.9999-1 of the Temporary Employment Tax Regulations, a payor may require an exempt recipient to furnish a Form W-9 or substitute form and may treat an exempt recipient who fails to furnish this certificate as a person who is not exempt. In addition, if the Form W-9 submitted by a payee to certify its exempt status does not contain a TIN, Q & A 16 of § 35a.9999-2 requires a payor to impose backup withholding.

Q & A 46 of § 35a.9999-3 provides that a payor is required to make an information return whenever the payor imposes backup withholding regardless of the amount of the payment. If tax is withheld under § 3406, an information return must be

made unless the amount is refunded by the payor. *See* Q & A 38 and 39 of § 35a.9999-3 and Rev. Proc. 84-80, 1984-2 C.B. 758.

Based on the foregoing, the following rulings are provided:

1. Interest earned on Client's funds deposited in Law Firm's IOLTA trust account and paid to the Foundation is not includible in the income of Client or Law Firm.

2. Generally, under § 6049 the Financial Institution is not required to report interest paid to the Foundation on an information return because the Foundation is an organization exempt from tax under § 501(a) and is thus an exempt recipient. However, if backup withholding is imposed and not refunded, the Financial Institution must file a Form 1099-INT on magnetic media with the Service and must furnish a payee statement to the Foundation. Law Firm is not required to report the interest paid to the Foundation because it is not the payor under § 6049.

A copy of this letter must be attached to any income tax return to which it is relevant. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayers who requested it, and it is based expressly on the unique facts represented by the taxpayers regarding the operation of the IOLTA program of State. The taxpayers may not continue to rely on this ruling if, at some future date, State modifies the IOLTA program. Section 6110(k)(3) provides that this ruling may not be used or cited as precedent.

Sincerely,

Assistant Chief Counsel
(Income Tax & Accounting)

By _____
Robert A. Berkovsky
Chief, Branch 2