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TAX & TRANSACTIONS BULLETIN

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Federal Estate Tax Credit Remains at $1.5 Million

- For calendar year 2005, the Federal estate tax credit remains at $1.5 million
- Every individual may transfer $1.5 million at death tax-free
- With Proper Planning, a married couple may transfer $3 million at death tax-free
- The Generation Skipping Tax (GST) Credit remains at $1.5 million
- The Illinois estate tax credit also remains at $1.5 million

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ESTATE TAX CREDIT REMAINS AT $1.5 MILLION

For calendar year 2005, the Federal Estate Tax Credit[1] remains at $1.5 Million. The Estate Credit is great news for the Family. With proper planning, a married couple currently may transfer $3 million to their children tax-free. This tax savings increases Family wealth.

People often desire to keep their wealth within the Family. Typically, a married couple distributes assets for each other during their joint lifetimes, and then distributes assets to younger generations. These distributions are subject to 3 transfer taxes: Gift tax, Estate tax, and Generation Skipping tax (GST). These 3 taxes are interrelated, and apply to all transfers of wealth from one individual to another.

Each tax has its own Credit. The Credit reduces tax on a dollar-for-dollar basis. A Credit thus permits tax-free transfers of Family wealth. The Credits assist a married couple in providing for each other during their joint lifetimes, and then distributing property to their children and grandchildren. Careful planning with Credits can maximize Family tax savings.

The Tax Credits, respectively, are as follows:

Year	Federal Estate Credit	Federal Gift Credit	Federal GST Credit	Illinois Estate Credit
2002 - 2003	$1,000,000	$1,000,000	$1,120,000[2]	$1,000,000
2004 - 2005	$1,500,000	$1,000,000	$1,500,000	$1,500,000
2006 - 2008	$2,000,000	$1,000,000	$2,000,000	$2,000,000
2009	$3,500,000	$1,000,000	$3,500,000	$2,000,000

The increased Estate Credit (and GST Credit) is highly beneficial for the Family. With proper planning, a married couple may, at death,[3] transfer $3 million to their children and grandchildren tax-free. This tax-free transfer permits greater

[1] Every U.S. taxpayer receives an Applicable Exclusion Amount which permits tax-free gifts during life or tax-free bequests upon death. This Applicable Exclusion Amount thus functions as a credit to reduce tax, and is conveniently referred to as the "Tax Credit".

[2] The GST credit was $1,100,000 in 2002, and $1,120,000 in 2003.

[3] Note that although both the Estate and GST Credits have increased since 2003, the Gift Credit did not increase. Thus, although a person may transfer $1.5 Million at death tax-free, a person may transfer only $1.0 Million during life tax-free. This discrepancy reflects the fact that Congress might lower the Estate Credit in the future. Congress does not want an individual to make tax-free lifetime gifts now, which exceed the amount the individual could transmit tax-free at death in the future.

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ESTATE TAX CREDIT REMAINS AT $1.5 MILLION (cont'd)

accumulations of Family wealth. (Note that both the Federal Estate tax and GST tax are scheduled to be repealed for individuals dying in 2010. Each tax is then reinstated in 2011. Many practitioners expect Congress to enact legislation prior to 2009, to clarify this situation).

Additional Federal tax laws which became effective January 1, 2005, are:

- The annual exclusion for gifts remains at $11,000.
- The annual exclusion for gifts to a non-citizen spouse increases to $117,000.
- The maximum Gift/Estate tax rate (and flat GST rate) is 47%.
- The state death-tax credit is eliminated. For decedents dying after 2004, a Federal deduction is allowed for state death taxes paid.[4]
- The deduction for a qualified family-owned business interest ("QFOBI") is repealed for estates of decedents dying after December 31, 2003.

[4] Code Section 2058(a).

CONTINGENT FEES PAID TO ATTORNEY ARE INCLUDED IN CLIENT'S INCOME

On January 24, 2005, the U.S. Supreme Court ruled unanimously that a client-plaintiff must include in her gross income that portion of litigation proceeds which is paid to her attorney as a contingent fee.[1]

Although attorneys typically collect fees based on billable hours, in certain cases an attorney may accept fees on a "contingent" basis. For example, in employment discrimination cases, an attorney may represent the employee on a contingent basis. In a contingent case the attorney receives payment solely from the litigation victory proceeds. If the attorney successfully recovers a monetary award for her client, the attorney receives a stated percentage (e.g. 40%) of the total recovery. In the past, the defendant often paid the contingent fees directly to the plaintiff's attorney, which bolstered the argument that the client-plaintiff never had control over the money.

The Supreme Court's ruling resolved a split among our Federal Courts of Appeals. The Court's rationale is that a contingent-fee lawyer does not become an owner of the client's claim. The client-plaintiff is sole owner of her claim. The claim is the "income generating asset." The Assignment of Income Doctrine requires that all claim proceeds are taxed to the client. For tax purposes the client is treated as receiving all claim proceeds, and then paying the contingent fee to her attorney. All litigation proceeds are included in the client's gross income.[2]

[1] *Commissioner v Banks*, U.S., No. 03-892 (1/24/2005); *Commissioner v. Banaitis*, U.S., No. 03-907 (1/24/05). In *Banaitis* the Supreme Court held that contingent fees which the defendant paid directly to the client-plaintiff's attorney are taxable income to the client. In *Banks* the Supreme Court held that contingent fees which the client-plaintiff paid to her attorney are taxable income to the client.

[2] Generally, money or property received pursuant to a judgment or settlement is includible in the recipient's gross income under Code Section 61. In personal injury cases, however, Code Section 104 excludes from income certain amounts received due to personal injuries or sickness. The tax policy behind this exclusion is that these amounts are intended to make the victim whole for the loss of physical well-being, and thus constitute a "nontaxable recovery of lost human capital."

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CONTINGENT FEES PAID TO ATTORNEY ARE INCLUDED IN CLIENT'S INCOME (cont'd)

Although the client's payment of the contingent fees to her attorney is deductible, this deduction may be worthless.[2] As a result, the client-plaintiff is fully taxed on her attorney's fees and (effectively) may receive no deduction.

The American Jobs Creation Act[3] of 2004 provides tax relief to certain plaintiffs. The Act creates a new above-the-line deduction[4] for attorney fees and court costs incurred by an individual in Civil Rights Lawsuits. Specifically, the new deduction applies to attorney fees and court costs in connection with a lawsuit involving (1) a claim of unlawful discrimination, (2) certain claims against the U.S. Government, and (3) a private cause of action under the Medicare Secondary Payer Statute. The new deduction cannot exceed the amount includable in the individual's gross income due to a judgment or settlement of the lawsuit. As an "above-the-line" deduction, these attorney fees and court costs will not be reduced on Schedule A, and will not be disallowed for AMT purposes.

In summary, practioners should plan carefully in this area.[5] Taxpayers entering into contingent legal fee arrangements should review all tax principles in advance. The tax treatment of a future recovery may affect the basic economic decision to proceed with the case.[6]

[2]This deduction may be worthless since it is a "below-the-line" miscellaneous itemized deduction, which is deductible for regular tax purposes only to the extent it exceeds 2 percent of adjusted gross income, and is not deductible at all for purposes of the alternative minimum tax (AMT).

[3]On October 22, 2004, President Bush signed the American Jobs Creation Act.

[4]The new above-the-line deduction provides tax relief only to certain plaintiffs. The "below-the-line" deduction is inadequate, and could result in a situation where a plaintiff owes more in income tax than the amount she actually recovers.

[5]A plaintiff may transfer a litigation claim to a third-party transferee prior to a final decision of the case. Provided the plaintiff-transferor receives valuable consideration and has a business purpose, the anticipatory assignment of income doctrine will not apply and the litigation proceeds payable to the transferee are also taxed to the transferee. PLR 200427009.

[6]IRS recently ruled in *PLR 200107019* that where punitive damages are paid to a charitable trust, the portion retained by the lawyer was includible in the client's income.

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