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TAX & TRANSACTIONS BULLETIN

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IRS Issues Final Rules for Split-Dollar Life Insurance

- IRS has issued Final Regulations for split-dollar life insurance polices
- The Final Regulations provide two (2) mutually exclusive regimes for taxation of split-dollar:
  - The Economic Benefit Regime
  - The Loan Regime
- *Effective Date:* The Final Regulations apply to any split-dollar life insurance arrangement entered into after September 17, 2003. Additionally, the Final Regulations apply to any split-dollar life insurance arrangement entered into on or before September 17, 2003, if the arrangement is materially modified after that date.

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IRS ISSUES FINAL RULES ON SPLIT-DOLLAR INSURANCE

The IRS has issued Final Regulations for split-dollar life insurance policies. The Final Regulations are effective for split-dollar arrangements entered into after September 17, 2003. Split-dollar includes any arrangement between an owner of a life insurance policy and a non-owner under which either party pays all or part of the premiums, and one of the parties paying premiums is entitled to recover a portion of those premiums from the policy proceeds.

The Final Regulations provide two (2) mutually exclusive regimes for taxation of split-dollar. The first regime is the Economic Benefit Regime. The second regime is the Loan Regime.

Ownership of the insurance policy determines which regime applies. The person named as policy owner of the insurance contract generally is the owner. Thus, the named owner of the policy determines which tax regime applies. Taxpayers can elect which regime will apply simply by designating a party as policy owner.[1]

Under the Economic Benefit Regime, the Corporation-Employer is named as policy owner.[2] The Corporation-Employer is treated as providing taxable economic benefits to the Employee. These taxable economic benefits include the cost of current life insurance protection, the amount of policy cash value to which the Employee has access, and any additional benefits provided to the Employee. Both the Corporation-Employer, and the Employee, must report these benefits for purposes of income tax, withholding tax, and gift tax.

Under the Loan Regime, the Employee is named as policy owner. As the Corporation-Employer pays premiums on the policy, each premium payment is treated as a separate loan from the Corporation-Employer (lender) to the Employee (borrower). If the loan fails to provide for a market rate of interest, the forgone interest is annually treated as transferred by the Corporation-Employer to the Employee as additional salary, and then re-transferred from the Employee to the Corporation-Employer as interest on the loan.[3] Both the Corporation-Employer, and the Employee, must report these transfers for purposes of income tax, withholding tax, and gift tax.

[1] IRS decided the named title owner of the policy would determine tax ownership and thus which regime applies, since (1) title ownership is often a factor in determining tax ownership, and (2) this rule provides a clear objective standard.
[2] The Economic Benefit Regime also applies automatically to split-dollar policies which provide solely current life insurance protection (i.e. non-equity split dollar).
[3] Code Section 7872.

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SPLIT-DOLLAR INSURANCE (cont'd)

The two regimes are simple in theory. If the Corporation-Employer is the owner, its premium payments are treated as providing taxable economic benefits to the Employee. These economic benefits include the Employee's interest in the policy cash value, and current life insurance protection. If the Employee is the owner of the policy, the Corporation-Employer's premium payments are treated as loans to the Employee. Unless the Employee is required to pay the Corporation-Employer market-rate interest on the loan, both parties will be taxed on the difference between market-rate interest and actual interest paid.

The Final Regulations determine taxation based on the relationship of the parties. Depending on the relationships among owner, non-owner, and 3rd parties (e.g. family members or Irrevocable Trusts for their benefit), the tax result may constitute a payment of salary, a dividend, a gift, a contribution to capital, or something else.

Failure to pay tax on the split-dollar policy today can create severe tax consequences tomorrow. Typically, a beneficiary pays no income tax on her receipt of life insurance proceeds. Code Section 101(a) excludes the death proceeds from the taxable income of the beneficiary. However, the Final Regulations limit this rule. The split-dollar proceeds are generally received tax-free only to the extent those proceeds are allocable to a split-dollar arrangement in which the parties properly reported and paid all tax. If the parties fail to pay tax on the split dollar arrangement during its operational years, the death proceeds may be subject to income tax.

The Final Regulations do not apply to "key man" life insurance. Under "key man," a company purchases insurance on the life of a key employee or shareholder, but retains all rights and benefits of the contract (including rights to all death benefits and cash value).

The Final Regulations do not address possible application of the Sarbanes-Oxley Act[4] to split-dollar arrangements. Thus, the Final Regulations do not address whether a split-dollar arrangement between a publicly-held company and one of its directors or executives constitutes a prohibited personal loan under the Sarbanes-Oxley Act. Administration of Sarbanes-Oxley is left to the SEC.

Effective Date. The final regulations apply to any split-dollar life insurance arrangement entered into after September 17, 2003. Additionally, the final regulations apply to any split-dollar life insurance arrangement entered into on or before September 17, 2003, if the arrangement is materially modified after that date.

The following Examples illustrate taxation of split-dollar under the Final Regulations:

Example 1

Corporation-Employer is Owner – Economic Benefit Regime Applies:[5]

Employer (R) is the owner and employee (E) is the non-owner of a life insurance contract that is part of a split-dollar life insurance arrangement. E does not make any premium payments. E reports on E's Federal income tax return for each year the split-dollar arrangement is in effect the amount of income required to be reported.

[4] Section 402 of the Sarbanes-Oxley Act of 2002 prohibits publicly-held companies from making personal loans to any director, executive officer, or equivalent employee.
[5] From Final Regulation 1.61-22(d)(6), Example 1.

SPLIT-DOLLAR INSURANCE (cont'd)

On January 1 of year 1, R and E enter into the split-dollar life insurance arrangement. Under the arrangement, R pays all of the premiums on the life insurance contract. Upon termination of the arrangement or E's death, R is entitled to receive the lesser of the aggregate premiums paid or the policy cash value of the contract and E is entitled to receive any remaining amounts. The policy cash value is fully accessible by R and R's creditors, but E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R. R purchases a life insurance contract with constant death benefit protection equal to $1,500,000. R makes premium payments on the life insurance contract of $60,000 in each of years 1, 2, and 3. The policy cash value equals $55,000 as of December 31 of year 1, $140,000 as of December 31 of year 2, and $240,000 as of December 31 of year 3.

Analysis. E has the right for year 1 and all subsequent years to borrow or withdraw the portion of the policy cash value exceeding the amount payable to R. Thus, E has current access to such portion of the policy cash value for each year that the arrangement is in effect. In addition, because R pays all of the premiums on the life insurance contract, R provides to E all of the economic benefits that E receives under the arrangement. Therefore, E includes in gross income the value of all economic benefits provided to E.

Results for year 1. For year 1, E is provided $0 of policy cash value (excess of $55,000 policy cash value determined as of December 31 of year 1 over $55,000 payable to R). For year 1, E is also provided current life insurance protection of $1,445,000 ($1,500,000 minus $55,000 payable to R). Thus, E includes in gross income for year 1 the cost of $1,445,000 of current life insurance protection.

Results for year 2. For year 2, E is provided $20,000 of policy cash value ($140,000 policy cash value determined as of December 31 of year 2 minus $120,000 payable to R). For year 2, E is also provided current life insurance protection of $1,360,000 ($1,500,000 minus the sum of $120,000 payable to R and $20,000 of aggregate policy cash value that E actually includes in gross income on E's year 1 and year 2 federal income tax returns). Thus, E includes in gross income for year 2 the sum of $20,000 of policy cash value and the cost of $1,360,000 of current life insurance protection.

Results for year 3. For year 3, E is provided $40,000 of policy cash value ($240,000 policy cash value determined as of December 31 of year 3 minus the sum of $180,000 payable to R and $20,000 of aggregate policy cash value that E actually included in gross income on E's year 1 and year 2 federal income tax returns). For year 3, E is also provided current life insurance protection of $1,260,000 ($1,500,000 minus the sum of $180,000 payable to R and $60,000 of aggregate policy cash value that E actually includes in gross income on E's year 1, year 2, and year 3 federal income tax returns). Thus, E includes in gross income for year 3 the sum of $40,000 of policy cash value and the cost of $1,260,000 of current life insurance protection.

Example 2:

Employee is Owner – Loan Regime Applies:[6]

On January 1, 2009, Employer X decides to provide split-dollar benefits to the family of B, an employee of X. Employer X enters into a split-dollar arrangement under which T, an irrevocable life insurance trust

[6] From Final Regulation 1.7872-15(e), Examples 1 and 2.

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SPLIT-DOLLAR INSURANCE (cont'd)

established for the benefit of A (B's child), is named as policy owner. T is not a grantor trust. On January 1, 2009, X makes a $30,000 premium payment, repayable upon demand without interest. Repayment of the premium payment is fully recourse to T. The payment is a below-market split-dollar demand loan.

Based on the relationships among the parties, the effect of the loan from X to T is to transfer value from X to B as taxable salary, and then to transfer value from B to T as a taxable gift. The below-market split-dollar loan from X to T is restructured as two deemed loans: a compensation-related loan between X and B; and a gift loan between B and T. Each of the deemed loans has the same terms and conditions as the original loan. Income tax, employment tax, and gift tax all apply to the transfers.

TAXATION OF COVENANTS NOT TO COMPETE, CORPORATE GOODWILL, AND PERSONAL GOODWILL WHEN BUYING OR SELLING A BUSINESS

Businesses are regularly bought and sold. Often, in connection with the sale, a majority shareholder or key employee resigns from the business and hands control to a successor. In many of these business-sale transactions, the departing owner signs a covenant not to compete ("Non-Compete") promising not to compete with the buyer. The structure and value placed on these Non-Competes can be critical to reducing tax on the sale. The sale of a business also often involves the buyer and seller allocating a portion of the sales price to Corporate Goodwill and/or Personal Goodwill. This article will examine the income tax treatment of Non-Competes and Goodwill from the perspectives of both buyer and seller in a business sale transaction, and will analyze recent cases to show tax savings techniques.

Reducing tax on the sale of a business requires advance planning. Tax planning will focus on the Choice of Legal Entity of both buyer and seller (e.g., C corporation, S corporation, Partnership, Limited Liability Company or Irrevocable Trust). Also important are the values placed on the seller's intangible assets. Intangible assets include goodwill and going-concern value. The seller's goodwill is defined as "the probability that the old customers will resort to the old place." The seller's going-concern value is defined as "the ability of a business to continue generating income without interruption notwithstanding a change in ownership." (Collectively, goodwill and going-concern value are referred to as "Goodwill"). Often, the residual selling price of a business in excess of the fair market value of all tangible assets is attributable to Goodwill.

The tax cost of selling a business is affected by treatment of the Goodwill. The tax cost is also affected by treatment of preexisting or newly-signed Non-Competes. Understanding the tax rules governing Goodwill and Non-Competes can reduce the cost of selling a business. This cost savings can benefit both buyer and seller.

Although Goodwill and Non-Competes are each intangible assets, the two are taxed differently. Taxation of both intangible assets was revised on August 10, 1993, with the enactment of Code Section 197. Since the pre-1993 rules occasionally still apply to current transactions, a review of both sets of rules is helpful.

TAXATON OF GOODWILL (cont'd)

The following tax rules apply to the Buyer and Seller of a business with intangible assets:

- Payments received by the Seller under a Non-Compete constitute ordinary income taxed at the highest rates
- On or before August 10, 1993, all payments made by the Buyer under a Non-Compete are deducted ratably over the years to which the contract relates
- After August 10, 1993, payments made by a taxpayer under a Non-Compete *generally* are deducted ratably over the years to which the contract relates
- After August 10, 1993, payments made by the Buyer under a Non-Compete *entered into in connection with a direct or indirect purchase of an interest in a business* are deducted ratably over fifteen (15) years
- If the Seller has a preexisting Non-Compete that prevents its employees and shareholders from taking clients, then the Seller owns the Goodwill (Corporate Goodwill)
- If the Seller fails to have a preexisting Non-Compete and its employees or shareholders are free to take clients, then those employees or shareholders individually own the Goodwill (Personal Goodwill)
- On or before August 10, 1993, no depreciation deduction was allowed for Goodwill, and the sale of Goodwill generated capital gain taxed at favorable rates
- After August 10, 1993, Goodwill acquired by purchase is depreciable and deducted ratably over 15 years ("Depreciable Goodwill")
- After August 10, 1993, Goodwill which is either self-created or was purchased from a 3rd party prior to August 11, 1993, is not depreciable ("Non-Depreciable Goodwill")
- After August 10, 1993, Depreciable Goodwill is not a capital asset, although it may qualify for capital gain treatment as a Section 1231 asset
- After August 10, 1993, Non-Depreciable Goodwill is a capital asset

In most corporate business-sale transactions, the buyer wants to purchase assets rather than stock of the corporation. An asset purchase gives the buyer an increased basis in the assets for future depreciation deductions, and avoids assumption of undisclosed or contingent corporate liabilities. An asset sale may cause double taxation, since a C corporation is taxed on its sale of assets and its shareholders are taxed again when the C corporation distributes the cash proceeds to them. Consequently, the seller wants a stock sale to achieve single taxation at favorable capital gains rates, and to transfer all liabilities.

Between these two positions lies room for negotiation and tax planning. Careful application of the rules governing Goodwill, Non-Competes, and Choice of Legal Entity often reduces tax on the transaction. The values assigned to Goodwill and Non-Competes may also reduce tax. Several recent cases illustrate the interplay of these rules.

TAXATION OF GOODWILL (cont'd)

Tax Court Upholds Characterization of Personal Goodwill

Martin Ice Cream Co., 110 TC 189 (3/17/1998) illustrates the rule that if the Seller fails to have a preexisting Non-Compete and its employees or shareholders are free to take clients, then those employees or shareholders individually own the Goodwill (Personal Goodwill). In *Martin Ice Cream* a parent corporation spun-off a subsidiary (in a failed Section 355 transaction) to Arnold Strassberg, who became sole shareholder of that subsidiary. Arnold had spent a lifetime developing personal client relationships and handshake-agreements related to the ice cream business. The subsidiary corporation sold its assets for cash. The sold assets primarily included Arnold's valuable client relationships and handshake-agreements. IRS claimed the sale proceeds should be taxed to the subsidiary corporation. However, the Tax Court held Arnold's client relationships and handshake-agreements were personal assets belonging to him. The court held the sale proceeds were taxable to Arnold (and not to the corporation), since Arnold personally had developed the client relationships. The corporation failed to own the client relationships because Arnold had never signed a Non-Compete. Arnold's client relationships were personal assets owned by him, since he had no Non-Compete or written employment agreement with the corporation. The Tax Court stated:

> *"Ownership of these intangible assets cannot be attributed to the corporation because Arnold never entered into a covenant not to compete with the corporation or any other agreement — not even an employment agreement — by which any of Arnold's distribution agreements, Arnold's relationships with the supermarkets, and Arnold's ice cream distribution expertise became the property of the corporation. This Court has long recognized that personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation. Those personal assets are entirely distinct from the intangible corporate asset of corporate goodwill."*

Martin Ice Cream confirmed that absent a Non-Compete, a shareholder's client relationships are personal assets and constitute Personal Goodwill. If the shareholder has a Non-Compete or written employment agreement with her corporation, however, then the shareholder's client relationships are corporate assets and constitute Corporate Goodwill. This simple rule has profound tax consequences. Goodwill often has a high dollar value. Parties should identify whether the Goodwill is a corporate asset or a personal asset. The characterization of substantial amounts of Personal Goodwill can mitigate the effect of double taxation at both the corporate and shareholder level where a transaction is structured as a corporate sale of assets.

IRS May Re-Characterize Allocations of Purchase Price by Buyer and Seller Among Intangible Assets

In *Langdon v. Commissioner, 91 AFTR 2d 2003-912 (8th Cir., 02/14/2003)*, the IRS successfully challenged the taxpayers' allocations of a portion of the purchase price between a Non-Compete and Goodwill. In this case, a pre-1993 case, a C corporation sold assets. An appraiser valued the corporation's Goodwill at $1 million. However, at closing the parties allocated no part of the purchase price to Corporate Goodwill. Rather, the parties allocated over $1 million to a 5-year Non-Compete signed by the sole shareholder of the selling corporation. Both buyer and seller benefited from this allocation. The buyer benefited since (under pre-1993 tax law) it could deduct the Non-Compete payments over the 5-year life of that agreement. If the buyer had allocated $1 million to Corporate Goodwill, it could not take depreciation deductions on the Goodwill, and could only recover its investment upon eventual sale or liquidation of the business. The seller also benefited, since the Non-Compete payments were taxed directly to the individual shareholder of the selling corporation, thus incurring a single tax. If the payments were allocated to Corporate Goodwill, double tax would ensue since the selling corporation would owe tax, followed by a second tax when the moneys (the $1 million less corporate taxes paid) were distributed as a dividend to the selling shareholder.

The Tax Court was well aware that both buyer and seller received tax benefits from allocating $1 million to

TAXATION OF GOODWILL (cont'd)

the Non-Compete. The court observed that in a business-sale transaction, IRS is not bound by the parties' allocation agreement. Rather, IRS can review the allocation agreement and set new values if the allocation is inappropriate. Two different standards apply to IRS' review of the parties' allocation. The court will give deference to the parties where they have competing tax interests. However, the court will strictly scrutinize the allocation where the parties have non-adverse tax interests. The court held that if the selling shareholder did compete with the buyer, he would remove $334,000 of business value. A rational buyer would therefore pay $334,000 for a Non-Compete signed by the selling shareholder. Consequently, the court re-characterized the $1 million payment. $334,000 was allocated to the Non-Compete and taxed once to the selling shareholder. $666,000 was allocated to Corporate Goodwill and taxed twice, first to the corporation and then to the selling shareholder upon distribution to him.

The court's reallocation of $666,000 to Corporate Goodwill caused both buyer and seller to owe additional tax. The buyer lost its deduction for payments originally allocable to the Non-Compete. The seller was subjected to double taxation on the $666,000. The Eighth Circuit stated:

> *"When one corporation buys the assets of another, the parties may agree to allocate the purchase price among the assets being acquired. The Internal Revenue Service, however, is not bound by the parties' allocation agreement. (Code Section 1060(a)). The Commissioner can review the allocation agreement and set new values if the allocation is not appropriate.*
>
> *When reviewing the parties' allocation agreement, two different standards apply. The tax court will give deference to the parties when they have competing tax interests. If, on the other hand, the parties do not have adverse tax interests, the tax court will strictly scrutinize the allocation agreement. Courts use a higher standard in such cases because competing tax interests deter allocations which lack economic reality.*
>
> *To determine whether the parties have correctly valued a covenant not to compete, courts must look to see if the allocation is grounded in economic reality. This means that the value of the covenant must be such that a reasonable person might bargain for it."*

In *Langdon*, the parties might have avoided additional tax liability by structuring the transaction differently. For instance, the selling corporation could ensure it has no Non-Compete with the selling shareholder prior to closing. The parties could then allocate all Goodwill to the selling shareholder as Personal Goodwill. This Personal Goodwill is taxed once at individual capital gains rates. Taxpayers can make a strong legal argument that Goodwill is a personal asset, whereas the dollar value assigned to a Non-Compete is subject to re-allocation by IRS.

An Unusual Situation: Allocation of Purchase Price to Corporate Goodwill (Rather than Personal Goodwill) Actually Decreases Federal Income Tax.

In *Jorgl v. Commissioner, 264 F.3d 1145 (11th Cir., 06/28/2001)*, John T. Jorgl was the sole shareholder of a C corporation conducting an active business. In 1991 John transferred all stock in the business to a charitable remainder trust ("CRT"). A CRT is an income tax-free vehicle which utilizes the charitable deduction to reduce estate taxes. In 1993 the CRT sold all stock for $650,000. The CRT's stock sale is normally tax-free. As a condition to sale of the business, John signed a Non-Compete for the buyer's benefit. The closing documents listed the value of the Non-Compete at $300,000. However, the CRT received all sale proceeds. No cash was distributed to John.

The 11th Circuit upheld the Tax Court's determination that executing the Non-Compete resulted in taxable income to John. $300,000 of the sales price was allocated to the Non-Compete and taxed to John. Even though he

TAXATION OF GOODWILL (cont'd)

never received any money, John owed tax. John was deemed to receive the $300,000, and then to have assigned this amount to the CRT.

John might have avoided tax by structuring the transaction differently. The *Jorgl* court relied on the fact that by executing the Non-Compete with the buyer, John acknowledged he owned Personal Goodwill. John had client relationships which belonged to him personally, and not to the corporation. Under the logic of *Martin Ice Cream*, however, John could have executed a Non-Compete with the corporation prior to the sale. By executing a prior Non-Compete, John would have transferred his Goodwill to the corporation. The corporation would then own all Goodwill. When the CRT later sold the corporation's stock, the entire sales price would be properly allocated to the stock and received tax-free by the CRT. No amount could be allocated to John.

Jorgl involves a situation where a higher value for Corporate Goodwill actually reduces tax. Usually, Corporate Goodwill increases tax due to the double taxation of C corporations. Parties therefore routinely assign value to Personal Goodwill, to avoid double taxation. In *Jorgl*, however, Personal Goodwill increased tax. The *Jorgl* stock sale involved a tax-exempt charitable remainder trust. The sale would be tax-free if the sales proceeds were allocable entirely to the stock. Those proceeds were allocable entirely to the stock, provided the corporation owned all tangible and intangible assets of the business. Since John had no preexisting Non-Compete with the corporation, however, he personally owned intangible assets of the business. A portion of business' value belonged to John personally, and this portion was taxable to John upon sale. The remaining portion of business' value belonged to the corporation, and was reflected in the value of its stock. *Jorgl* illustrates that careful application of tax principles is essential. Without careful planning, allocations of intangible asset-value can increase tax liability.

Stock Redemptions May be Treated as an Acquisition of a Business and Trigger Code Section 197

In *Frontier Chevrolet Co., 116 TC 289 (05/14/2001)*, an active business conducted as a C corporation redeemed all stock owned by a 75% majority shareholder. In connection with this stock redemption, the corporation became obligated to make Non-Compete payments to the departing 75% shareholder for five years. The corporation sought to deduct the Non-Compete payments over the five-year life of that contract.

The Tax Court held the corporation's stock repurchase constituted an indirect acquisition of a business interest, since the corporation reacquired control of its stock and its former minority shareholder effectively bought-out the departing 75% shareholder. Because there was an acquisition of a business interest, Code Section 197 applied. Therefore, the corporation's Non-Compete payments had to be deducted over fifteen years (not five).

Frontier Chevrolet Co. is surprising because typically practitioners do not view a stock redemption as the acquisition of a business interest. However, in *Frontier Chevrolet Co.* the redemption resulted in the minority shareholder buying-out the majority shareholder. The redemption was comparable to an outright purchase of the business by the minority shareholder. Code Section 197 therefore applied and required the corporation to deduct its Non-Compete payments over 15 years.

In summary, tax planning is essential to save money on business-sale transactions. Careful application of the rules governing Personal Goodwill, Corporate Goodwill, Non-Competes, and Choice of Legal Entity may reduce tax on the transaction. The value assigned to intangible assets may also reduce tax.

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ATTORNEY'S CONTINGENT FEES INCLUDED IN CLIENT'S INCOME

In the Summer 2003 issue of our Tax & Transactions Bulletin, we discussed the income tax treatment of litigation proceeds. Generally, amounts recovered in personal physical injury cases and mental injury cases are not includible in income for federal tax purposes. In other cases, the amounts recovered may or may not be includible in income, based on the origin and nature of the claim.

In situations where the recovery is includible in income, there is a conflict among our Federal Courts of Appeals on whether an attorney's contingent fee should be taxed to the client, even though the attorney received and paid tax on all contingent fee moneys and the client never received the money.

Although attorneys generally collect their fees based on their hourly time, in some cases the attorneys may accept fees on a "contingent" basis. For example, in employment discrimination cases, it is not unusual for the attorney to represent the employee on a contingent basis. A contingent case means the attorney receives payment solely out of the victory proceeds. Thus, if the attorney successfully recovers a monetary award for her client, the attorney receives a stated percentage (e.g. 40%) of the total recovery.

The tax issue concerns whether a client-plaintiff must include in income that portion of the proceeds received by her attorney as a contingent fee. Recently, a number of courts have focused on this tax issue. The issue is sufficiently complex that it has divided the Federal Courts of Appeals.

In *Kenseth v. Commissioner, 7th Cir. (No. 00-3705, 8/7/01)*, the Seventh Circuit held that under Wisconsin law a contingent-fee lawyer does not become an owner of the client's claim. Therefore, the client-plaintiff is sole owner of the claim, and all proceeds from the claim belong to the client. For tax purposes, the client is treated as receiving the claim proceeds, and then paying the attorney his (contingent) portion of the proceeds. Based on this analysis, the entire amount of the claim proceeds are included in the gross income of the client. Although the client's payment of the contingent attorneys fees is generally deductible, this deduction may be worthless where the deduction (being incurred by an individual and unrelated to a trade or business) is a miscellaneous itemized deduction. Such an item is deductible for regular tax purposes only to the extent it exceeds 2 percent of adjusted gross income, and is <u>not deductible at all</u> for purposes of the alternative minimum tax (AMT). [Of course, if the claim proceeds are related to a trade or business, or if the party receiving the proceeds is a non-individual taxpayer such as a corporation, the full amount of the contingent attorney's fees should generally be deductible].

The result is that an individual Plaintiff pays tax on her lawyer's fees, even though those fees are distributed directly from the defendant to Plaintiff's lawyer and the Plaintiff never has control over the fee-moneys. In *Kenseth*, the Client's Plaintiff owed an additional $17,000 in tax. 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.

Until such time as Congress or the Supreme court addresses this issue, practioners should act carefully. Taxpayers entering into contingent legal-fee arrangements with respect to claims, the recovery of which may result in taxable income, should be aware of the tax rule for their specific jurisdiction.

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