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A Source of Revenue for the Improvement of Legal Services, Part II: A Recommendation for the Use of Clients' Funds Held by Attorneys in Non-Interest-Bearing Trust Accounts to Support Programs of the Texas Bar Association and an Analysis of the Federal Income Tax.

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COMMENTS

A SOURCE OF REVENUE FOR THE IMPROVEMENT OF LEGAL SERVICES, PART II: A RECOMMENDATION FOR THE USE OF CLIENTS' FUNDS HELD BY ATTORNEYS IN NON-INTEREST-BEARING TRUST ACCOUNTS TO SUPPORT PROGRAMS OF THE TEXAS BAR ASSOCIATION AND AN ANALYSIS OF THE FEDERAL INCOME TAX RAMIFICATIONS

TAYLOR S. BOONE

INTRODUCTION

Certain clients' funds held in trust by attorneys may be used to support programs of the organized bar. Often an attorney will hold clients' funds in trust, but because of the small amount of these funds or the short period during which they will be held, the attorney simply places the funds in a non-interest-bearing checking account. The Florida Bar Association and the Florida Supreme Court have recognized that if all of these funds, which would otherwise remain idle, were aggregated in a trust savings account, significant interest income could be earned.[1] Consequently, the Florida Supreme Court has established a voluntary plan by which attorneys may place clients' funds otherwise held in demand accounts in trust savings accounts with the interest accruing to support public legal programs.[2] In a prior comment, the history of the concept embodied in the Florida plan is discussed, the Florida plan is analyzed, and alternatives are offered.[3] This comment will recommend a similar plan for Texas, analyze the federal income tax ramifications of that plan, and make additional recommenda-

1. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 801-03 (Fla. 1978). The concept embodied in the Florida plan is based on two premises. First, the costs an attorney will incur in accounting for the earnings on clients' funds will exceed the earnings when the principal is small and the duration of the investment is short. Second, an attorney will not incur additional expenses in placing small quantities of clients' funds in savings accounts with the interest therefrom accruing to a third party not specifically designated by agreement. *Id.* at 801.

2. *See id.* at 809-11.

3. *See* Comment, *A Source of Revenue for the Improvement of Legal Services, Part I: An Analysis of the Plans in Foreign Countries and Florida Allowing the Use of Clients' Funds Held by Attorneys in Non-Interest-Bearing Trust Accounts to Support Programs of the Organized Bar,* 10 ST. MARY'S L.J. 539, 542-63 (1979) [hereinafter cited as Comment, *A Source of Revenue for the Improvement of Legal Services*].

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tions to remedy the tax consequences that might disable the concept embodied in the Florida and proposed Texas plans.

A Plan for Texas

Background

A Reason for Change. In its May 1974 hearings, the United States Senate Subcommittee on Representation of Citizen Interests concluded that many Americans were not receiving adequate legal services.[4] Citizens in Texas are no exception, since it has been recently estimated that seventy percent of Texas residents are without adequate legal services.[5] In fact, a survey revealed that sixty-seven percent of all Texas residents seventeen years or older do not have a will, and less than half of all Texans twenty-two years or older do not consult an attorney before buying or leasing real estate.[6] Attorneys in Texas and the Texas Bar Association are aware of their duty to make available to all people acceptable legal service[7] and have responded to this need by promoting legal aid programs, lawyer referral services,[8] and more recently, prepaid legal services.[9] Cost is one of many factors that have limited the availability of legal services;[10] the plan recommended in this comment may be used to furnish additional revenue for legal services and other programs sponsored by the Bar Association.

An Attorney's Duties and Obligations When Managing a Client's Money. The disciplinary rules of Canon 9 of the Code of Professional Responsibility mandate that an attorney avoid even an "appearance of impropriety" and require an attorney to preserve the "identity of funds and

4. *See* Comment, *Legal Services Within Reach of the Average American: A Review of the Tunney Hearings,* 27 BAYLOR L. REV. 603, 603-05 (1975).

5. *See* Jones, *Prepaid Legal Services Come of Age,* 38 TEX. B.J. 901, 901 (1975); Comment, *How Prepaid Legal Services Will Affect The Public,* 27 BAYLOR L. REV. 621, 621 (1975).

6. Jones, *Prepaid Legal Services and the Organized Bar,* 27 BAYLOR L. REV. 411, 412 n.2 (1975).

7. *See* State Bar of Texas, Rules and Code of Professional Responsibility, Canon 2 (1973) [hereinafter cited as State Bar of Texas Code]; Jones, *Prepaid Legal Services Come of Age,* 38 TEX. B.J. 901, 901-02 (1975). Canon 2 provides: "A Lawyer Should Assist the Legal Profession in Fulfiling Its Duty to Make Legal Counsel Available." State Bar of Texas Code, Canon 2 (1973).

8. *See* State Bar of Texas Code EC 2-25 (1973); State Bar of Texas, *State Bar of Texas Reply to Sunset Staff Report,* 41 TEX. B.J. 1031, 1044 (1978).

9. *See* TEX. INS. CODE arts. 23.01 - .26 (Vernon Supp. 1963-1978) (chapter 23, Non-Profit Legal Services Corporations); Jones, *Prepaid Legal Services Come of Age,* 38 TEX. B.J. 901, 901 (1975); Richnow, *Marketing Prepaid Legal Services to Meet the Consumer's Demand,* 27 BAYLOR L. REV. 421, 421-25 (1975).

10. *See* Comment, *The Shreveport and Columbus Plans of Prepaid Legal Services—An Analysis of Plans Presently in Operation,* 27 BAYLOR L. REV. 485, 485 (1975). In addition to the cost of legal services limiting the availability of those services, many people are unaware of their legal rights and of the procedures by which legal services can be obtained. *See id.* at 485.

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property of a client."[11] Disciplinary Rule 9-102 specifically requires an attorney to deposit clients' funds in "one or more identifiable bank accounts" and not to commingle clients' funds with those of his own.[12] Although there has been very little litigation concerning Disciplinary Rule 9-102, a Texas court has held that an attorney need not act fraudulently, culpably, or willfully in order to violate the prohibition against commingling clients' funds with his own.[13] Furthermore, even a client's consent to allow his attorney to commingle their funds will not excuse the attorney from the requirements of the Code.[14]

When attorneys hold money for a client, they often do so pursuant to an agreement with the client forming an express trust.[15] Consequently, in addition to complying with the disciplinary rules of the Code of Professional Responsibility,[16] the attorney must abide by the directions of the trust agreement[17] and the provisions of the Texas Trust Act.[18] As a trustee, an attorney "must act in good faith and exercise that degree of care and diligence that an ordinarily prudent person would exercise in the management of his own affairs."[19] When the trust agreement gives no direction for the investment of trust funds, the trustee has the duty to make the fund productive by investing in a proper investment medium.[20] The trustee, however, is not required to invest the funds if within a very short time trust funds are to be distributed or if an investment would in any way place the

11. *See* State Bar of Texas Code DR 9-101 & 9-102 (1973).

12. State Bar of Texas Code DR 9-102(A) (1973). Rule 9-102(A) provides two exceptions: an attorney may deposit his funds in a client's account, (1) when it is necessary to pay bank charges and (2) when the client's funds belong in part to the attorney. *Id.*

13. *See* Archer v. State, 548 S.W.2d 71, 73 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

14. *See id.* at 74.

15. An express trust can be created in a number of ways, one of which is simply an agreement in writing. *See* Miller v. Donald, 235 S.W.2d 201, 205 (Tex. Civ. App.—Fort Worth 1950, writ ref'd n.r.e.); TEX. REV. CIV. STAT. ANN. art. 7425b-7 (Vernon 1960). An attorney may agree to hold funds for a client for the purpose of closing a purchase of sale of real estate, the settlement of an estate, or the collection of a debt.

16. *See* State Bar of Texas Code DR 9-102 (1973).

17. *See* Hays v. Harter, 177 S.W.2d 797, 798 (Tex. Civ. App.—El Paso 1943, writ ref'd); John Hancock Mut. Life Ins. Co. v. Duval, 96 S.W.2d 740, 743 (Tex. Civ. App.—Eastland 1936, writ ref'd).

18. *See* TEX. REV. CIV. STAT. ANN. art. 7425b-46A (Vernon Supp. 1978-1979).

19. McMullen v. Sims, 37 S.W.2d 141, 144 (Tex. Comm'n App. 1931, holding approved); *see* TEX. REV. CIV. STAT. ANN. art. 7425b-46A (Vernon Supp. 1978-1979); *cf.* Frost Nat'l Bank v. Kayton, 526 S.W.2d 654, 660-61 (Tex. Civ. App.—San Antonio 1975, writ ref'd n.r.e.) (duty of administrator to care for estate is similar to that of trustee).

20. *See* Levin v. Commissioner, 355 F.2d 987, 990 (5th Cir. 1966) (applying Texas law); Moore v. Sanders, 106 S.W.2d 337, 339 (Tex. Civ. App.—San Antonio 1937, no writ). If a trustee does have a reasonable opportunity to make the trust funds productive, his failure to do so can render him personally liable for interest the funds could have earned. *See* Langford v. Shamburger, 417 S.W.2d 438, 444-45 (Tex. Civ. App.—Fort Worth 1967, writ ref'd n.r.e.).

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corpus of the trust in danger.[21] Since the primary consideration in the investment of a trust fund is safety,[22] a trustee should not invest when an investment would yield a loss.[23] If a trustee deposits trust funds in his own bank account, he will not only be liable for interest at the highest legal rates,[24] but he will also bear the responsibility of separating the trust property from his personal property.[25] Any checks drawn on a trustee's commingled account are deemed to be drawn from the trustee's own funds,[26] and if the trustee cannot separate the trust funds from his own, the whole account will be treated as trust property.[27]

Framework for Developing a Plan in Texas

Before specific recommendations can be made for adopting a plan in Texas, a review is necessary of existing concepts or organizations that could become a part of the plan, as well as the obstacles that might be encountered. A short discussion of the history of the client security fund in Texas and the Texas Bar Foundation is valuable in determining whether

21. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bocock, 247 F. Supp. 373, 379 (S.D. Tex. 1965) (safety is first consideration when investing trust fund); Humane Soc'y v. Austin Nat'l Bank, 531 S.W.2d 574, 580 (Tex. 1975) (investment decisions must consider safety of trust fund), *cert. denied*, 425 U.S. 976 (1976); Moore v. Sanders, 106 S.W.2d 337, 339 (Tex. Civ. App.—San Antonio 1937, no writ) (when funds can be applied immediately or within short period of time, trustee has no duty to invest).

22. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bocock, 247 F. Supp. 373, 379 (S.D. Tex. 1965); Humane Soc'y v. Austin Nat'l Bank, 531 S.W.2d 574, 580 (Tex. 1975), *cert. denied*, 425 U.S. 976 (1976).

23. For example, if an attorney knew that his administrative costs for processing any investment of a small trust would exceed the yield, his only prudent course of action would be to place the money in a non-interest-bearing demand deposit. Usually a trustee is entitled to be reimbursed for administrative or operating expenses incurred in carrying out the trust. *See, e.g.*, Central R.R. & Banking Co. v. Pettus, 113 U.S. 116, 122-23 (1885); Trustees v. Greenough, 105 U.S. 527, 532-36 (1881); Van Gemert v. Boeing Co., 573 F.2d 733, 735 (2d Cir. 1978). *See generally* TEX. REV. CIV. STAT. ANN. art. 7425b-4(K) (Vernon 1960) & art. 7425b-36 (Vernon Supp. 1978-1979).

24. *See, e.g.*, Langford v. Shamburger, 392 F.2d 939, 945 (5th Cir. 1968) (applying Texas law); Ward v. Maryland Cas. Co., 140 Tex. 124, 130, 166 S.W.2d 117, 121 (1942); Anderson v. Armstrong, 132 Tex. 122, 131, 120 S.W. 2d 444, 450 (1938).

25. *See* Barrington v. Barrington, 290 S.W.2d 297, 301 (Tex. Civ. App.—Texarkana 1956, no writ); Farrow v. Farrow, 238 S.W.2d 255, 256 (Tex. Civ. App.—Austin 1951, no writ); Spencer v. Pettit, 17 S.W.2d 1102, 1106 (Tex. Civ. App.—Amarillo 1929), *aff'd*, 34 S.W.2d 798 (Tex. Comm'n App. 1931, judgmt adopted).

26. *See, e.g.*, Continental Nat'l Bank v. Weems, 69 Tex. 489, 500, 6 S.W. 802, 806 (1888); General Ass'n of Davidian Seventh Day Adventists, Inc. v. General Ass'n of Davidian Seventh Day Adventists, 410 S.W.2d 256, 259 (Tex. Civ. App.—Waco 1966, writ ref'd n.r.e.); United States Fidelity & Guar. Co. v. First Nat'l Bank, 81 S.W.2d 213, 216 (Tex. Civ. App.—Fort Worth 1935, writ dism'd).

27. *See* Farrow v. Farrow, 238 S.W.2d 255, 256 (Tex. Civ. App.—Austin 1951, no writ); Spencer v. Pettit, 17 S.W.2d 1102, 1106 (Tex. Civ. App.—Amarillo 1929), *aff'd*, 34 S.W.2d 798 (Tex. Comm'n App. 1931, judgmt adopted).

both will be amenable to the plan recommended for Texas.

Rules Governing an Attorney's Duties Concerning Money Held for Clients. In formulating plans by which the funds of attorneys' clients would be used to support certain programs of the organized bar, policy-makers must consider article 317 and Disciplinary Rule 9-102 of the Code of Professional Responsibility.[28] Article 317 requires an attorney to pay upon demand the money he receives or collects for a client.[29] Failure of an attorney to abide by this article may subject him not only to a judgment for the funds he refuses to return, but also to mandatory damages between ten and twenty percent of the principal sum.[30]

Unlike the rules in Florida, which prescribe not only the duties of an attorney when he is in control of clients' funds, but also how an attorney is to satisfy these duties,[31] the rules in Texas give an attorney much more flexibility, leaving the manner of satisfaction of the duties within the discretion of the attorney.[32] These duties require an attorney licensed in Texas to place clients' funds in bank accounts separate from his own,[33] to notify clients without delay of receipt of their funds,[34] to "maintain complete records" of each client's funds,[35] and to pay or deliver promptly a client's funds upon request.[36]

Client Security Fund in Texas. Although Texas does have a client security fund, it exists in relative obscurity.[37] Discussion of a client security

28. *See* TEX. REV. CIV. STAT. ANN. art. 317 (Vernon 1973); State Bar of Texas Code DR 9-102 (1973).

29. TEX. REV. CIV. STAT. ANN. art. 317 (Vernon 1973).

30. *See id.*

31. *See* FLA. STAT. ANN., Bar Integration Rule 11.02(4) (West Supp. 1968-1978) (as amended by *In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 808-09 (Fla. 1978), which added additional accounting requirements to accomodate Florida plan); FLA. STAT. ANN., Code of Professional Responsibility DR 9-102 (West Supp. 1968-1978) (as amended by *In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 807-09 (Fla. 1978), to allow deposits of clients' funds in savings and loan associations). The Florida Bar Integration Rule 11.02(4) as amended not only requires an attorney to return a client's money upon demand, but also prescribes exactly what records must be maintained for funds held in trust by an attorney and which accounting procedures must be followed. *See* FLA. STAT. ANN., Bar Integration Rule 11.02(4) (West Supp. 1968-1978) (as amended by *In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 700, 808-09 (Fla. 1978)); Comment, *A Source of Revenue for the Improvement of Legal Services, supra* note 3, at 550-51.

32. *Compare* FLA. STAT. ANN., Bar Integration Rule 11.02(4) (West Supp. 1968-1978) *and* FLA. STAT. ANN., Code of Professional Responsibility DR 9-102 (West Supp. 1968-1978) *with* TEX. REV. CIV. STAT. ANN. art. 317 (Vernon 1973) *and* State Bar of Texas Code DR 9-102(1973).

33. *See* State Bar of Texas Code DR 9-102(A) (1973).

34. *See id.* (B)(1).

35. *Id.* (B)(3).

36. *Id.* (B)(4).

37. *See* State Bar of Texas, *State Bar Directors Meet,* 38 TEX. B.J. 519, 519 (1975); State Bar of Texas, *State Bar of Texas Reply to Sunset Staff Report,* 41 TEX. B.J. 1031, 1044-45

fund for Texas began as early as June 1960, when the General Counsel of the State Bar advised the bar directors that the fund could not be supported by dues from attorneys because of constitutional restraints.[38] In 1973 the State Bar proposed legislation creating a client security fund to be financed by assessing members of the bar.[39] Although this legislation failed,[40] the Board of Directors of the State Bar approved creation of the fund and rules of procedure for its operation.[41]

The client security fund was created to compensate individuals who suffered pecuniary losses because of the dishonesty of attorneys licensed in Texas.[42] Each year since the inception of the fund, the State Bar has appropriated $25,000 for the payment of claims;[43] however, only one claim of $10,000 has been paid.[44] The rules of procedure for the administration of the fund limit the size of any claims to not more than $20,000[45] and strictly define "dishonest conduct" and "reimbursable losses."[46]

(1978); Sunset Commission Staff, *Staff Report on State Bar of Texas,* 41 TEX. B.J. 819, 835-36 (1978).

38. *See* Wray, *A New Way to Serve Our Clients: The Clients' Security Fund,* 35 TEX. B.J. 1023, 1024 (1972). The Texas Constitution prohibits the expenditure of public funds, which attorneys' dues are thought to be, for private purposes. *See* TEX. CONST. art. III, § 51. The Board of Directors believed the constitution prohibited the use of attorneys' dues to support the client security fund and recommended that a constitutional amendment be introduced to the Sixty-third Legislature in 1973. *See* Wray, *A New Way to Serve Our Clients: The Clients' Security Fund,* 35 TEX. B.J. 1023, 1024 (1972).

39. *See* Sunset Commission Staff, *Staff Report on State Bar of Texas,*41 TEX. B.J. 819, 851 (1978).

40. *See id.* at 851.

41. *See* State Bar of Texas, *State Bar Directors Meet,* 38 TEX. B.J. 519, 519 (1975); State Bar of Texas Client Security Fund Committee, Rules of Procedure Client Security Fund Proceedings, Final Draft (March 25, 1975) (unpublished rules of procedure furnished upon request by State Bar of Texas).

42. *See* State Bar of Texas, *State Bar of Texas Reply to Sunset Staff Report,* 41 TEX. B.J. 1031, 1044-45 (1978); Sunset Commission Staff, *Staff Report on State Bar of Texas,* 41 TEX. B.J. 819, 835-36 (1978); Wray, *A New Way to Serve Our Clients: The Clients' Security Fund,* 35 TEX. B.J. 1023, 1024 (1972).

43. *See* State Bar of Texas, *State Bar of Texas Reply to Sunset Staff Report,* 41 TEX. B.J. 1031, 1044 (1978).

44. *See* State Bar of Texas, *Clients' Security Fund Pays First Claim,* 40 TEX. B.J. 806, 806 (1977). Since only $10,000 has reportedly been paid from the client security fund, there is a conflict between articles by the State Bar concerning the number of payments made from the fund. *Compare id.* at 806 ("$10,000 check was mailed to an elderly widow") *with* State Bar of Texas, *State Bar of Texas Reply to Sunset Staff Report,* 41 TEX. B.J. 1031, 1045 (1978) ("To date the Fund has reviewed several cases and has approved payments totaling $10,000.").

45. *See* Rules of Procedure Client Security Fund Proceedings, Rule 103 G 7 (April 12, 1975) (unpublished rules adopted by Board of Directors, State Bar of Texas).

46. *See id.* Rules 103 F & G. Dishonest conduct means any wrongful act "committed by a lawyer in the manner of defalcation or embezzlement of money, or the wrongful taking or conversion of money, or the wrongful taking or conversion of money, property, or other things of value." *Id.* Rule 103 F. Reimbursable losses are defined as:

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Texas Bar Foundation. In 1958 the State Bar Legal Aid Committee proposed the creation of a foundation to accept contributions to advance legal aid work and other services to the public by the State Bar of Texas.[47] Seven years later the Board of Directors of the State Bar authorized the creation of a committee to study the possibility of creating a bar foundation to expand continuing legal education and other activities of the State Bar.[48] During November 1965 the Texas Bar Foundation was finally organ-

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those losses of money, property or other things of value which meet all of the following tests:

1. The loss was caused by the dishonest conduct of a lawyer when:
   (a) Acting as a lawyer, or
   (b) Acting in a fiduciary capacity customary to the practice of law, such as administrator, executor, trustee of an express trust, guardian, or conservator; or
   (c) Acting as an escrow holder or other fiduciary, having been designated as such by a client or having been so appointed or selected as a result of a client-attorney relationship in the manner in which the loss arose.
2. The loss was that of money, property or other things of value which came into the hands of the lawyer by reason of having acted in the capacity described in Paragraph G1 of this Rule.
3. The dishonest conduct occurred on or after the effective date of these Rules.
4. The following shall not be an applicant:
   (a) The spouse or close relative, partner, associate, employer, or employee of the lawyer, or
   (b) An insurer, surety or bonding agency or company, or
   (c) Any business entity controlled by (i) the lawyer,
   (ii) any person described in Paragraph (a) hereof, or
   (iii) any entity either described in Paragraph (b) hereof or in turn controlled by the lawyer or a person or entity described in Paragraphs (a) or (b) hereof, or
   (d) A governmental entity agency.
5. The loss, or reimbursable portion thereof, was not covered by any insurance or by any fidelity or similar bond or fund, whether of, the lawyer or the applicant or otherwise.
6. Either:
   (a) The lawyer
   (i) has died or has been adjudicated mentally incompetent;
   (ii) has been disciplined, or has voluntarily resigned from the practice of law in Texas;
   (iii) has become a judgment debtor of the applicant or has been adjudicated guilty of a crime, which judgment or judgments shall have been predicated upon dishonest conduct while acting as specified in Paragraph G1 of this Rule and which judgment or judgments remain unsatisfied in whole or in part; or
   (b) The Committee [Client Security Fund Committee] has determined it to be an appropriate case for consideration under these Rules.
7. No application shall be allowed in excess of $20,000 for losses to any applicant arising out of the dishonest conduct of any one lawyer.

Id. Rule 103 G.

47. *See* State Bar of Texas, *Bar Directors Meet,* 21 Tex. B.J. 282, 282 (1958).

48. *See* State Bar of Texas, *Bar Directors Meet,* 28 Tex. B.J. 444, 444 (1965).

ized as a non-profit corporation,[49] exempt from federal income taxes under section 501(c)(3) of the Internal Revenue Code.[50] The Foundation was established to promote continuing legal education, to expand legal aid for the poor, to support legal research, and to create legal scholarships.[51]

Contributions required of lawyers chosen to become fellows of the Texas Bar Foundation have been an excellent source of funds for the corpus of the Foundation, which was valued at $574,904 the fiscal year ending May 31, 1976.[52] Only the earnings from the corpus have been expended for grants, which have increased from $11,688 in fiscal year ending May 31, 1972, to $39,435 in fiscal year ending May 31, 1976.[53] Grants have been made for various purposes, such as rewriting the Family and Penal Codes, developing standards of qualifications for indigent loan programs, and supporting the client security fund.[54] In 1974 the Foundation became trustee of the continuing legal education (CLE) trust fund, previously held by the State Bar, and assumed responsibility for activities of the CLE pro-

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49. *See* Jones, *The Profession's Foundation,* 29 TEX. B.J. 159, 159 (1966).

50. *See* TEXAS BAR FOUNDATION, 1974-1975 YEARBOOK 5 (1974); Jones, *The Profession's Foundation,* 29 TEX. B.J. 159, 159 (1966). Two factors must have influenced the State Bar in choosing a tax free foundation. First, the Board of Directors must have realized that any contribution to the State Bar might be classified as public funds and thus become subject to the constitutional restriction prohibiting the expenditure of public funds for private purposes. *See* TEX. CONST. art. III, § 51. Second, the Board of Directors must have contemplated that a tax exempt foundation, also qualifying as a charitable organization, would increase donations, while at the same time allowing the foundation to earn income free from federal income tax. *See* I.R.C. § 170 (deduction for "Charitable, etc., contributions and gifts") & § 501(c)(3) (certain organizations exempt from tax).

51. See TEXAS BAR FOUNDATION, 1974-1975 YEARBOOK 5 (1974). Article four of the articles of incorporation of the Texas Bar Foundation states:

> The purpose or purposes for which the corporation is organized are educational and charitable; that is to say, the corporation is formed to support, promote and encourage activities for the furtherance of justice and legal education through the sponsorship and encouragement of legal research, publications, institutes, forums, and the establishment of scholarships; the institution and maintenance of legal aid facilities for the indigent and the acceptance of aid and grants from governmental and private sources; provided, that the foregoing is limited by the following: That the funds of the corporation will not be expended for investigation or prosecution of grievances against members of the State Bar of Texas, or other attorneys, or for the purpose of carrying on propaganda or otherwise attempting to influence legislation.

Id. at 43.

52. *See* State Bar of Texas, *Audits,* 39 TEX. B.J. 1023, 1028 (1976). The Foundation is governed by the Directors of the State Bar, and membership and related contributions to the Foundation are controlled by the by-laws of the Fellows of the Texas Bar Foundation. *See* TEXAS BAR FOUNDATION, 1974-1975 YEARBOOK 5, 46-47 (1974).

53. *Compare* State Bar of Texas, *State Bar, Bar Foundation Audits,* 36 TEX. B.J. 1172, 1174 (1973) *with* State Bar of Texas, *Audits,* 39 TEX. B.J. 1023, 1028-29 (1976).

54. *See* State Bar of Texas, *Audits,* 39 TEX. B.J. 87, 92, 1023, 1029 (1976); State Bar of Texas, *State Bar, Bar Foundation Audits,* 36 TEX. B.J. 1172, 1174 (1973); State Bar of Texas, *Texas Bar Foundation,* 35 TEX. B.J. 1110, 1110 (1972).

gram of the State Bar.[55]

Obstacles to a Plan in Texas. The most apparent legal obstacles to the implementation of a plan by which attorneys would place clients' non-interest-bearing funds in trust savings accounts are the conflicts that could arise among state and federal banking regulations, the Code of Professional Responsibility, and article 317 of the Revised Civil Statutes. Federal banking regulations prohibit the payment of interest on demand deposits of banks subject to federal regulations.[56] Consequently, any plan adopted in Texas will necessitate the use of savings accounts.[57] Federal regulations empower any federally licensed bank or any state-chartered bank insured by the Federal Deposit Insurance Corporation to require a thirty-day notice before funds may be withdrawn from savings accounts;[58] a Texas statute provides savings and loan associations may require a sixty-day notice.[59] If a bank or savings and loan association were to exercise its right to notice, an attorney might be placed in conflict with Disciplinary Rule 9-102(B)(4) and article 317, which require an attorney to repay funds held for a client upon demand.[60] This conflict can be avoided, however, if a bank or savings

55. *See* State Bar of Texas, *Audits,* 39 TEX. B.J. 87, 92, 1023, 1029 (1976); State Bar of Texas, *News, Professional Headnotes,* 37 TEX. B.J. 401, 401 (1974).

56. *See* 12 U.S.C. § 371a (1970); 12 C.F.R. §§ 217.2(a) (part of Regulation Q of Federal Reserve Board), 329.2(a) (part of regulations promulgated by Federal Deposit Insurance Corporation) (1978).

57. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 801-03 (Fla. 1978); Comment, *A Source of Revenue for the Improvement of Legal Services, supra* note 3, at 552-53. Only seven states, Massachusetts, Connecticut, Rhode Island, Maine, Vermont, New York, and New Hampshire, are allowed to use negotiable orders of withdrawal (NOW) accounts, which may be described as interest-bearing accounts subject to withdrawal upon demand by draft. *See* 12 U.S.C. § 1832(a) (Supp. V 1975), *as amended by* State Taxation of Depositories Act of 1976, Pub. L. No. 94-222, § 2, 90 Stat. 197 (1976) *and* Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, § 1301, 92 Stat. 3712 (1978). The Federal Reserve Board has promulgated regulations effective November 1, 1978 allowing all federally chartered banks to offer a system of withdrawal from savings accounts, a system the savings and loan association industry has criticized as being too similar to negotiable order of withdrawal accounts. *See* 43 Fed. Reg. 20001, 20001-02 (1978) (to be codified as 12 C.F.R. § 217.5(c)(2)). Under this new provision a bank may automatically transfer funds from a depositor's savings accounts to cover checks drawn by the depositor in excess of the checking account balance or to maintain a minimum balance in the checking account. *See id.* A distinguishing factor of this automatic transfer system from NOW accounts is the power of banks to require a thirty-day notice prior to transfer of funds from savings to demand accounts. *See id.*

58. *See* 12 C.F.R. §§ 217.1(e)(2) (part of Regulation Q of Federal Reserve Board), 329.1(e)(1)(iii) (part of regulations promulgated by Federal Deposit Insurance Corporation) (1978). Any banking institution organized under Texas laws may, with consent of the state banking commissioner, enter into obligations with the Federal Deposit Insurance Corporation to insure deposits. *See* TEX. REV. CIV. STAT. ANN. art. 489b, § 2 (Vernon 1973).

59. *See* TEX. REV. CIV. STAT. ANN. art. 852a, § 6.19 (Vernon Supp. 1978-1979) (bylaws of savings and loan association may require sixty days notice).

60. *See id.* art. 317 (Vernon 1973) (refusal by attorney to pay upon demand may subject

and loan association contracts to waive any right to notice of withdrawal.[61] This contracted waiver of the right to notice of withdrawal is included in the plan recommended for Texas; the problems associated with this contract are discussed in the recommendation.

Recommendations for a Plan in Texas

Manner of Enacting Recommendation and Vehicle for Implementation. Two means, at least, are available for enacting recommendations that follow in this comment. The State Bar could request the legislature to enact legislation specifically creating a plan, or the Texas Supreme Court, under authority of the State Bar Act, could promulgate regulations enacting a plan.[62] Since the State Bar Act was enacted to provide a comprehensive and complete set of laws for the practice of law and the regulation and discipline of attorneys,[63] and since the supreme court is delegated the responsibility to accomplish the legislative purpose,[64] perhaps it would be best if the court enacted the plan with the consent of attorneys in Texas.[65]

Vital to the plan by which clients' funds that otherwise remain idle in demand deposits are placed in trust savings accounts is the determination of who is to receive the interest from these savings accounts. The Florida plan does not direct interest to the Florida Bar Association but instead to a bar foundation;[66] two compelling reasons exist for a similar arrangement in Texas. First, since the State Bar is considered a state agency,[67] any money received by the State Bar may be subject to constitutional provi-

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attorney to judgment for amount withheld plus between ten and twenty percent penalty); State Bar of Texas Code DR 9-102(B)(4) (1973) (lawyer must pay or deliver promptly to client).

61. *See* 12 C.F.R. §§ 217.1(e)(2), 329.1(e)(1)(iii) (1978). If a bank does make a waiver of its right to notice of withdrawal, it would also have to waive its right to notice from all other depositors who are subject to the same remaining contractual provisions. *See id.* §§ 217.5(a), 329.5(a).

62. *See* TEX. REV. CIV. STAT. ANN. art. 320a-1, § 4(a) (Vernon 1973). The Texas Supreme Court may "prepare and propose rules and regulations for . . . the operation, maintenance, and conduct of the State Bar" and may prescribe "a code of ethics governing the professional conduct of attorneys at law." *Id.* Proposed rules must be mailed to each attorney licensed in Texas, and these rules become effective only if fifty-one percent of the licensed attorneys vote, and if the majority of those voting are in favor of the proposed rules. *Id.*

63. *See* McGregor v. Clawson, 506 S.W.2d 922, 928 (Tex. Civ. App.—Waco 1974, no writ); State *ex rel* Chandler v. Dancer, 391 S.W.2d 504, 508-09 (Tex. Civ. App.—Corpus Christi 1965, writ ref'd n.r.e.).

64. *See* TEX. REV. CIV. STAT. ANN. art. 320a-1, § 4(a) (Vernon 1973).

65. The plan in Florida was promulgated by the Florida Supreme Court. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 799-800, 807 (Fla. 1978).

66. *See id.* at 807.

67. *See* McGregor v. Clawson, 506 S.W.2d 922, 926 (Tex. Civ. App.—Waco 1974, no writ); TEX. REV. CIV. STAT. ANN. art. 320a-1, § 2(a) (Vernon 1973).

sions prohibiting the use of public money by individuals.[68] Although the term "public money" is not defined in the Texas Constitution,[69] court interpretations of the term are so broad[70] that it would be wise to avoid transmittal of the interest in the trust savings accounts to the State Bar. As in the Florida plan, the earnings should accrue to an organization that is not controlled by the state, such as a bar foundation.[71] The decision whether interest should accrue to the Texas Bar Foundation may be influenced by the uses to which the revenue might be applied.[72]

Second, the interest should not accrue to the State Bar because it may very well not qualify as a tax deductible, charitable organization.[73] Since interest from savings accounts is taxable income,[74] the Internal Revenue Service can be expected to argue that someone must pay federal income taxes. Therefore, the plan should provide some possible relief for the party taxed—a tax deductible, charitable contribution.[75] Once again, the Texas

68. *See* State v. City of Austin, 160 Tex. 348, 355, 331 S.W.2d 737, 742-43 (1960); TEX. CONST. arts. III, § 51 & XVI, § 6. Article III, section 51 prohibits the legislature from granting any public money to individuals, associations of individuals, or corporations, except to certain Confederate soldiers and sailors; the prohibition does not apply "in cases of public calamity." *Id.* art. III, § 51. Article XVI, section 6 prohibits any appropriation "for private or individual purposes . . . unless authorized by this Constitution"; subsection (b) delineates when public money may be used to aid the mentally and physically handicapped. *Id.* art. XVI, § 6.

69. *See id.* arts. III, § 51 & XVI, § 6.

70. *See* Beaumont, S.L. & W. Ry. v. State, 173 S.W. 641, 642 (Tex. Civ. App.—Galveston 1914, no writ); Tarrant County v. Butler, 80 S.W. 656, 659 (Tex. Civ. App. 1904, no writ). "By 'public money,' . . . the framers of the Constitution most probably meant moneys received by officers of the state, and belonging to the state, derived in the ordinary processes of taxation, and *in other ways permissible under the Constitution.*" *Id.* at 659 (emphasis added). As an indication that money accepted by a state agency from private sources will be considered public money, article XVI, section 6(b) of the Texas Constitution states that money donated to state agencies for assistance of the mentally and physically handicapped is state money. TEX. CONST. art. XVI, § 6(b).

71. *Compare* FLA. STAT. ANN., Bar Integration Rule art. XII (West 1967) (authorizing Florida Bar Foundation as a distinct entity) *with* TEXAS BAR FOUNDATION, 1974-1975 YEARBOOK 5, 43-45 (1974) (Texas Bar Foundation organized as nonprofit corporation separate from state government).

72. *See* TEXAS BAR FOUNDATION, 1974-1975 YEARBOOK 5, 43 (1974). The Foundation prohibits the use of funds for investigation or prosecution of grievances against attorneys licensed in Texas. *See id.* at 43.

73. *See* Rev. Rul. 77-232, 1977-2 C.B. 71-72. The Internal Revenue Service does not consider state bar organizations as agencies of state government because these organizations have no meaningful sovereign powers. *See id.* at 71. Furthermore, since state bars, such as that in Texas, have dual purposes, public—regulation of attorneys, and private—furtherance of continuing legal education, section 170(c)(1) of the Code is not applicable because a contribution to a governmental organization is deductible only if made for public purposes. *See* I.R.C. § 170(c)(1); Rev. Rul. 77-232, 1977-2 C.B. 71. All references herein to the Code or sections thereof will be to the Internal Revenue Code of 1954 unless otherwise specifically noted.

74. *See* I.R.C. § 61(a)(4).

75. *See* I.R.C. § 170(c) (defining charitable contribution).

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Bar Foundation qualifies, for it is a tax deductible, charitable organization.[76]

Legal Programs to be Funded from the Earnings of Clients' Trust Funds. In choosing which legal programs are to be funded from the earnings of clients' trust funds, great care should be taken to avoid even the appearances of professional impropriety.[77] Since laymen may be unfamiliar with the benefits of legal programs that do not affect the public directly, funding of legal libraries and continuing education courses might be misunderstood by the general public, further diminishing public confidence in the legal system and legal profession.[78]

The Florida plan authorizes the use of earnings from clients' funds for such purposes as aid to the poor, augmentation of the client security fund, operation of a more expedient grievance mechanism, and the provision of student loans.[79] Some of the plans enacted by Canadian provinces allow the use of earnings from clients' funds for the establishment, operation, and maintenance of libraries.[80] If the Texas Bar Foundation is chosen to administer a plan in Texas, many of the activities that it currently supports could continue to be funded, such as contributions to the client security fund, expansion of legal aid, and research on legal matters.[81] Use of earnings from clients' funds for buildings to serve the legal profession and for expansion of continuing legal education may appear to the layman as a conflict of interest.[82] Investigation and prosecution of grievances

76. *See* TEXAS BAR FOUNDATION, 1974-1975 YEARBOOK 5 (1975); I.R.C. §§ 170 (c)(2)(B), 501(c)(3).

77. *See* State Bar of Texas Code, Canon 9 (1973) ("A Lawyer Should Avoid Even the Appearance of Professional Impropriety"); Comment, *A Source of Revenue for the Improvement of Legal Services, supra* note 3, at 559-60.

78. *See* Comment, *A Source of Revenue for the Improvement of Legal Services, supra* note 3, at 560.

79. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 811 (Fla. 1978); Comment, *A Source of Revenue for the Improvement of Legal Services, supra* note 3, at 555. A problem has surfaced with some of the programs the Florida Bar Foundation wishes to fund; the Internal Revenue Service has challenged some programs as not falling within the guideline for exemption under section 501(c)(3) of the Internal Revenue Code. Telephone interview with John A. Boggs, State Bar of Florida (March 1979); *see* I.R.C. § 501(c)(3) (organizations exempt from tax).

80. *See* Comment, *A Source of Revenue for the Improvement of Legal Services, supra* note 3, at 548.

81. *See* TEXAS BAR FOUNDATION, 1974-1975 YEARBOOK 5 (1974). The Foundation has made grants for the support of the client security fund. *See* State Bar of Texas, *Audits*, 39 TEX. B.J. 87, 91, 1023, 1029 (1976).

82. If attorneys' assessments for state bar buildings and their fees for legal seminars are reduced, the net economic effect would be to enrich attorneys. Although the ethical considerations of Canon 9 of the Code of Professional Responsibility do not indicate that it is in any way improper to use earnings from clients' funds to build state bar buildings or to underwrite continuing legal education, those actions appear in conflict with the ethical considerations of Canon 5. *Compare* State Bar of Texas Code, Canon 9 (1973) (avoiding appearance of

against attorneys, an activity funding of which is prohibited by Bar Foundation rules,[83] should be considered for support even to the exclusion of the Bar Foundation as the administrative agent of the plan.[84]

Election by an Attorney To Participate in a Plan. When an amount of money held by an attorney for his client is so small or is to be held for such a short period of time that the money cannot be invested economically, the attorney, upon consent of the client, should have the option of placing the funds in a trust savings account with the interest accruing to support various legal programs.[85] Any plan considered for Texas should be voluntary, as is the plan in Florida.[86] Not until the concept has been tested in Texas for several years, should a mandatory plan even be considered.[87] Significantly, the duty of an attorney to invest clients' funds would probably not be altered whether the plan was voluntary or mandatory.[88]

Determination whether a client's funds can be invested economically depends on a number of factors including the risk of investment, the amount of the funds, and the estimated duration of the trust. If the duration of the trust is estimated to be relatively short, six months or less, the funds should be maintained in a stable, liquid investment, such as a savings account or short-term certificate of deposit.[89] If funds are to be held

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professional impropriety) *with id.* Canon 5 (exercising professional judgment in behalf of client). Ethical Consideration 5-1 provides:

> The professional judgment of a lawyer should be exercised, within the bounds of the law, *solely* for the benefit of his client and free of compromising influences and loyalties. Neither *his personal interests,* the interests of other clients, nor the desires of *third persons* should be permitted to dilute his loyalty to his client.

Id. EC 5-1 (emphasis added).

83. *See* Texas Bar Foundation, 1974-1975 Yearbook 5 (1974).

84. *See* State Bar of Texas, *State Bar of Texas Reply to Sunset Staff Report,* 41 Tex. B.J. 1031, 1059 (1978); Sunset Commission Staff, *Staff Report on State Bar of Texas,* 41 Tex. B.J. 819, 868-69 (1978).

85. The alternative would be for the client's funds to remain idle in demand deposits.

86. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 804, 809 (Fla. 1978); Comment, *A Source of Revenue for the Improvement of Legal Services, supra* note 3, at 554.

87. The Florida Bar envisions a mandatory program when federal banking laws and regulations are relaxed to allow "payment of interest on checking accounts or the writing of checks on savings accounts." *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 804 (Fla. 1978).

88. *Cf.* Levin v. Commissioner, 355 F.2d 987, 990 (5th Cir. 1966) (applying Texas law) (trustee has duty to invest additions to corpus); Moore v. Sanders, 106 S.W.2d 337, 339 (Tex. Civ. App.—San Antonio 1937, no writ) (trustee must make fund productive if corpus not too small or not paid out soon). A trustee who had a reasonable opportunity to make trust funds productive may render himself liable for interest the funds could have earned. *See* Langford v. Shamburger, 417 S.W.2d 438, 444-45 (Tex. Civ. App.—Fort Worth 1967, writ ref'd n.r.e.).

89. Consideration could be given to other investment media, such as government securities. If the length of the trust extends over a year, a trustee should consider long-term, higher yield investments, such as blue chip corporate bonds.

only one or two days, it would be unreasonable to require an attorney even to place those funds in a savings account.[90] As the estimated duration of the trust increases, however, the amount of money required to earn interest in excess of the administrative costs will decrease, and in this situation the attorney should invest the funds for the benefit of the client.[91]

Elements of a Plan for Texas. Since the primary function of a trustee is to provide for the safety of the corpus of a trust,[92] any bank or savings and loan association in which clients' funds are placed should be insured either by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation.[93] In establishing the eligibility of insured banks and savings and loan associations as depositories for attorneys' trust

90. A financial institution's bookkeeping delays alone may prevent interest from accruing on a deposit the day it is made.

91. In the following example, a cost of five dollars is assumed to cover the administrative charges an attorney would incur in establishing, accounting for, and withdrawing a savings deposit for a client. Consequently, the size of the principal that must be deposited to offset the five dollar charge is listed below, varied only by the length of the deposit. An interest rate of 5.5% is assumed, and interest is not compounded.

$$\text{Size of deposit} = \frac{\text{Interest Required (\$5.00)} \times 365 \text{ days}}{\text{Interest Rate (5.5\%)} \times \text{Number of days of deposit}}$$

Number of Days	Size of Principal Required to Earn $5.00 Interest
1	$33,182
5	6,636
10	3,318
15	2,212
20	1,569
30	1,106
50	664
100	332

Before a plan is adopted a study should be made to determine an average administrative cost to process a simple savings account for one client. The five dollar estimate may not be unreasonable as many businesses now charge at least five dollars just to reprocess a returned check.

92. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bocock, 247 F. Supp. 373, 379 (S.D. Tex. 1965); Humane Soc'y v. Austin Nat'l Bank, 531 S.W. 2d 574, 580 (Tex. 1975), *cert. denied,* 425 U.S. 976 (1976).

93. The Federal Deposit Insurance Corporation insures each account up to $40,000; the Federal Savings and Loan Insurance Corporation up to $40,000 per account. *See* 12 C.F.R. §§ 330.10 (1978), *as amended by* 43 Fed. Reg. 58081 (1978) & 564.2 (1978), *as amended by* 43 Fed. Reg. 10548 (1978). In addition, both organizations impose and enforce rules of operation on participating financial institutions to prevent the need of ever having to honor a claim. *See generally id.* §§ 325.0-343.11 (FDIC), 561.1-571.13 (FSLIC). If the Texas plan provides that an attorney may place clients' funds in savings and loan associations, the Texas Supreme Court should amend Disciplinary Rule 9-102(A). *See* State Bar of Texas Code DR 9-102(A) (1973).

savings accounts, the Florida plan should not be followed. Under Florida's plan only those institutions that have not exercised their rights to the thirty-day or sixty-day withdrawal notice within the past five years are qualified.[94] Besides being questionable as retroactive,[95] a five year requirement does not ensure that an institution, otherwise qualifying, will not require a withdrawal notice in the future.[96] A better alternative would be for an attorney to contract with banks and savings and loan associations for waiver of their right to notice of withdrawal.[97] A contractual waiver would ensure that an attorney could withdraw funds upon demand and would eliminate any need for the Bar Foundation to maintain an emergency fund.[98]

A financial institution will not waive any right voluntarily unless it is profitable or is necessary because of competition. Consequently, the drafters of a Texas plan might consider negotiating a waiver of a bank's right to withdrawal notice for a reduced interest rate to be paid on the trust savings accounts.[99] Unlike the plan in Florida, which requires the rate of interest on the trust saving accounts to be not less than the interest rate on all regular savings accounts,[100] the plan in Texas could allow a one-quarter to one-half percent reduction from the maximum rate on regular

94. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 809 (Fla. 1978) (codified in FLA. STAT. ANN., Bar Integration Rule 11.02(4)(d)(ii) (West Supp. 1968-1978)).

95. *Cf.* McCord v. Smith, 43 So. 2d 704, 708-09 (Fla. 1949) (retroactive provision of legislative act invalid when additional disabilities imposed because of prior acts). Retroactive laws are specifically prohibited in Texas. TEX. CONST. art. I, § 16.

96. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 809 (Fla. 1978).

97. A federally chartered bank or a state chartered bank insured by the Federal Deposit Insurance Corporation may waive its right to notice withdrawal. *See* 12 C.F.R. §§ 217.1(e)(2), 329.1(e)(1)(iii) (1978). If a bank makes such a waiver, it must also waive its right to notice for all other depositors with identical depository contracts. *See* 12 C.F.R. §§ 217.5(a), 329.5(a)(1978).

98. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 809-10 (Fla. 1978) (codified in FLA. STAT. ANN., Bar Integration Rule 11.02(4)(d)(iv) (West Supp. 1968-1978)). If a bank does require a thirty-day notice of withdrawal, thereby preventing an attorney from honoring a client's demand, the attorney may request funds from the Bar Foundation to meet the client's emergency needs. *See id.* at 809. The Foundation, solely at its discretion, may advance the attorney an amount of funds within limits promulgated by the Foundation. *See id.* at 809-10; Comment, *A Source of Revenue for the Improvement of Legal Services, supra* note 3, at 561-67.

99. Federal banking regulations prescribe only the maximum interest rates that may be charged on various deposits. *See* 12 C.F.R. §§ 217.3, .7, *as amended by* 43 Fed. Reg. 21436, 24516, 26425 (1978), 44 Fed. Reg. 16361 (1979) & 329.3, .6 (1978), *as amended by* 43 Fed. Reg. 21437, 24270 (1978), 44 Fed. Reg. 15477 (1979).

100. *See In re* Interest on Trust Savings Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 810 (Fla. 1978) (codified in FLA. STAT. ANN., Bar Integration Rule 11.02(4)(d)(v) (West Supp. 1968-1978)).

savings accounts to encourage institutions to waive their notice requirements and to compensate for any additional accounting required of the institution.[101] The drafters of a plan should also consider that some savings and loan associations may not have any notice requirements and would be willing to pay the maximum interest on savings accounts.[102]

Two other elements of a plan must be established and may also be negotiated by the Bar to entice financial institutions to waive the notice requirements. The first element is the account balance on which interest will be calculated and compounded. A number of alternatives are available: a daily balance, average monthly balance, or even an average quarterly balance.[103] The second element is the frequency of payment of interest by the bank: monthly, quarterly, or annually.[104] Factors to be considered include the cash flow demands of the various programs funded under the plan and the benefits the financial institutions realize by retaining depositors' earned interest as long as possible.

No matter what agreements are reached on interest rates, balances, and the frequency of payments, the plan should require all interest to be transmitted directly by the bank or savings and loan association to the organization administering the plan rather than to the attorney or firm responsible for the trust account.[105] This will avoid needless paperwork and eliminate opportunities for defalcations by the respective attorneys. The financial institutions should be further instructed to prepare two statements when payments are made: one for the administrating organization, stating at least the amount transferred, the responsible attorney or firm, the account balance, and the interest rate applied; the other statement for the responsible attorney, stating among other things, the account balance, the interest paid, and the rate of interest applied.[106]

101. The Florida Bankers Association opposed the adoption of the Florida plan for a number of reasons, one of which was the lack of reimbursement for the additional accounting costs that banks would encounter from increased activity in the trust savings accounts. *See In re* Interest on Trust Savings Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 806 (Fla. 1978).

102. The bylaws of a savings and loan association may provide for up to sixty days advance notice of withdrawal. *See* TEX. REV. CIV. STAT. ANN. art. 852a, § 6.19 (Vernon Supp. 1978-1979).

103. The Florida plan uses the average monthly balance. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 810 (Fla. 1978) (codified in FLA. STAT. ANN., Bar Integration Rule 11.04(4)(d)(vi)(A) (West Supp. 1968-1978)). If the account balance is estimated to be relatively constant, a greater amount of interest could be earned if calculated and compounded on a daily basis.

104. Florida requires remittance of interest at least quarterly. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 810 (Fla. 1978) (codified in FLA. STAT. ANN., Bar Integration Rule 11.04(4)(vi)(A) (West Supp. 1968-1978)).

105. The Florida plan follows this procedure. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 810 (Fla. 1978) (codified in FLA. STAT. ANN., Bar Integration Rule 11.04(4)(vi)(A) (West Supp. 1968-1978)).

106. These statements are needed to give both the attorney and the administering organ-

Avoiding Problems of Due Process

It is well-settled that a state cannot take private property without affording the owner both procedural and substantive due process.[107] An owner, however, may voluntarily waive his right to due process, just as he may waive many other of his constitutional rights.[108] Courts will not presume that a person has waived a constitutional right;[109] any waiver must be shown to have been made knowingly, voluntarily, and intelligently.[110] The Florida plan includes the supreme court's recognition of the need of consent from clients for the use of their funds,[111] but the manner in which the consent is obtained is difficult to reconcile with the requirements for knowing, voluntary, and intelligent waivers.[112]

To avoid questions of due process, any attorney who elects to participate in the Texas plan should obtain from a client for whom he holds money a consent that the client's funds that would not otherwise be economically invested, may be invested for the benefit of legal programs and a waiver to any and all interest earned from the funds so invested. To ensure that a client makes a knowing, voluntary, and intelligent waiver, an attorney and his client should execute when practical an agreement that specifies the following:[113]

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ization an accurate accounting record and to provide a form of check and balance. The Florida plan included the requirements of two statements. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 810 (Fla. 1978) (codified in FLA. STAT. ANN., Bar Integration Rule 11.04 (4)(d)(vi)(B) & (C) (West Supp. 1968-1978)).

107. *See* Boddie v. Connecticut, 401 U.S. 371, 378-80 (1971) (substantive); Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 314-15 (1950) (procedural). *See generally* U.S. CONST. amends. V & XIV. Procedural due process requires that a person be given notice of the proceeding against him and an opportunity to defend himself, and that the propriety of the deprivation must be resolved in a manner consistent with fairness. *See* Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 314-15 (1950). Substantive due process may be defined generally as the constitutional guarantee that no person will be deprived of life, liberty, or property for arbitrary reasons, whether by unreasonable legislation or legislation unreasonably applied. *See, e.g.*, Poe v. Ullman, 367 U.S. 497, 543 (1961) (Harlan, J., dissenting); Nebbia v. New York, 291 U.S. 502, 525 (1934); Missouri Pac. Ry. v. Humes, 115 U.S. 512, 519-20 (1885).

108. *See* D.H. Overmyer Co. v. Frick Co., 405 U.S. 174, 185-87 (1972) (rights to notice and hearing prior to civil judgment).

109. *See, e.g.*, Smith v. United States, 337 U.S. 137, 150 (1949) (privilege against self-incrimination); Aetna Ins. Co. v. Kennedy, 301 U.S. 389, 393 (1937) (right to trial by jury); Ohio Bell Tel. Co. v. Public Utils. Comm'n, 301 U.S. 292, 307 (1937) (right to object to actions of administrative agencies).

110. *See, e.g.*, D.H. Overmyer Co. v. Frick Co., 405 U.S. 174, 185-87 (1972); Brady v. United States, 397 U.S. 742, 748 (1970); Johnson v. Zerbst, 304 U.S. 458, 464 (1938).

111. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 807, 810-11 (Fla. 1978).

112. *See* Comment, *A Source of Revenue for the Improvement of Legal Services, supra* note 3, at 557-59.

113. If the question of waiver is ever litigated, the burden of proof will be on the party

1. An explanation of the duties of an attorney acting as trustee to invest funds for the benefit of the trust or the client.[114]
2. An explanation that small amounts of money to be held in trust for short periods of time cannot be invested economically.[115]
3. A simple guideline by which a client can judge whether the size and duration of his trust will enable it to be invested economically.[116]
4. An explanation that an attorney cannot commingle his funds with those of his clients, and that a client's funds must be available for immediate withdrawal.[117]
5. An explanation that the Texas Supreme Court has initiated a new program by which clients' funds that would otherwise remain in demand deposits may be invested, upon consent of clients, in trust savings accounts with the interest accruing to the benefit of public legal programs.[118]
6. A summary of the legal programs that may be funded.[119]
7. An explanation that a client has the options of: requiring his funds to remain in demand deposits, requiring an attorney to invest his funds even though the resultant attorney's fees will exceed the earnings, or allowing his funds to be placed in a trust savings account with the interest accruing to support public legal programs.[120]
8. An explanation that upon failure of a client to execute the agreement his funds held in trust will remain in demand deposits unless they can be invested economically.[121]

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asserting that a valid waiver has been made. *See, e.g.*, Fuentes v. Shevin, 407 U.S. 67, 94-96 (1972); Gonzales v. County of Hidalgo, 489 F.2d 1043, 1046 (5th Cir. 1973); United States v. White, 429 F. Supp. 1245, 1251 (N.D. Miss. 1977). If for no other reason than to protect an attorney and ease his burden of proof, an explicit waiver should be executed.

114. See notes 19-23 *supra* and accompanying text.

115. The explanation might emphasize that the additional bookkeeping costs could very well exceed interest earned on a small, short-term trust. *See* Comment, *A Source of Revenue for the Improvement of Legal Services, supra* note 3, at 539.

116. See note 91 *supra* and accompanying text. If the client is not given guidelines by which he can ascertain whether funds can be invested for his benefit, it is questionable if that client could make a knowing and intelligent waiver.

117. See notes 12-14 & 24-27 *supra* and accompanying text.

118. A similar explanation would be appropriate if a plan is legislatively enacted.

119. A client might very well refuse consent for the use of his funds if he knew the legal programs that were to be funded. Furthermore, without knowledge of how the interest might be used, a client could not give a valid consent.

120. An attorney must abide by the directions of the trust agreement. *See* Hays v. Harter, 177 S.W.2d 797, 798 (Tex. Civ. App.—El Paso 1943, writ ref'd); *cf.* John Hancock Mut. Life Ins. Co. v. Duval, 96 S.W.2d 740, 743 (Tex. Civ. App.—Eastland 1936, writ ref'd) (testator's desires stated in will must be followed as closely as possible). Consequently, the client should be given the option to require his funds to be invested even though the costs of this function might exceed any earnings. If a client is not given notice of all his options, he might assert he did not make an intelligent waiver.

121. Courts will not presume waiver of an individual's constitutional rights. *See, e.g.*, Smith v. United States, 337 U.S. 137, 150 (1949); Aetna Ins. Co. v. Kennedy, 301 U.S. 389, 393 (1937); Ohio Bell Tel. Co. v. Public Utils. Comm'n, 301 U.S. 292, 307 (1937). The Florida plan is questionable for it assumes a client has given his consent to the use of his funds unless the Florida Bar Foundation is notified otherwise. *See In re* Interest on Trust Accounts, a

9. A statement that the client knowingly, voluntarily, and intelligently consents to the use of his funds held in trust by his attorney and waives any right to the interest earned that is to accrue to a specific organization for the support of public legal programs.[122]

ANALYSIS OF FEDERAL INCOME TAX RAMIFICATIONS

The Plans Are in Jeopardy

If a plan is adopted in Texas similar to that in Florida whereby clients' funds that would otherwise remain in non-interest-bearing demand accounts are placed in trust savings accounts, interest will be earned for the benefit of certain legal programs.[123] Since interest is a form of income,[124] it is subject to federal income tax. As will be developed further, the imposition of income tax places the Florida and Texas plans in serious jeopardy. Although it may be possible to avoid payment of any income tax, the excessive accounting requirements necessary to comply with the Internal Revenue Code might invalidate one of the premises upon which the plans are founded. The Internal Revenue Service can be expected to assert two doctrines to support their proposition that the client is taxable for the interest earned: grantor trusts and assignment of income. In the following discussion, the term grantor is used synonymously for the term client.

Taxing the Client

Grantor Trusts. The trusts authorized under the Florida plan and proposed for Texas will cause the client/grantor of the trust to recognize any income earned by the funds in the trust. Subpart E, or sections 671 through 679 of Subchapter J of the Code, as a general rule, require the owner of the trust to consider in computing his taxable income, the income, deductions, and credits of the trust.[125] The principle underlying these sections provides that "income of a trust over which the grantor . . . has retained

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Petition of the Florida Bar, 356 So. 2d 799, 811 (Fla. 1978); Comment, *A Source of Revenue for the Improvement of Legal Services, supra* note 3, at 557-58.

122. *See* TEX. REV. CIV. STAT. ANN. art. 317 (Vernon 1973); State Bar of Texas Code DR 9-102 (1973).

123. Like the concept embodied in the Florida plan, the recommended Texas plan is based on two premises. First, the costs an attorney will incur in accounting for the earnings on clients' funds will exceed the earnings when the principal is small and the duration of the investment is short. Second, an attorney will not incur additional expenses in placing small quantities of clients' funds in savings accounts with the interest therefrom accruing to a third party. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 801 (Fla. 1978).

124. *See* I.R.C. § 61(a)(4). Interest from savings accounts is a prime example of taxable interest income. *See* Treas. Reg. § 1.61-7(a), T.D. 6873, 1966-1 C.B. 101.

125. *See* I.R.C. §§ 671-679; Note, *Treatment of the Grantor Trust as a Separate Entity*, 32 TAX. L. REV. 409, 410-11 (1977).

substantial dominion or control should be taxed to the grantor . . . rather than to the trust . . . or to the beneficiary . . . ."[126] The regulations further define the income to be attributed to the grantor as "income determined for tax purposes" and not "income for trust accounting purposes."[127]

Subpart E contains a number of provisions specifying when an ordinary trust becomes a grantor trust;[128] two of these provisions are particularly applicable to the trusts of the Florida plan and the Texas proposal. First, a trust providing a reversionary interest in the grantor or his estate that is reasonably expected to take effect within ten years qualifies as a grantor trust under section 673(a).[129] The trusts of the two plans fit squarely within this provision since the trusts are short term, and the client will regain possession of the corpus within ten years.[130] Second, a trust enabling the grantor to revoke the trust any time before the expiration of ten years qualifies under section 676(a) as a grantor trust.[131] Again, the trusts authorized under the two plans qualify as grantor trusts because the grantor/client may revoke at anytime by requesting his attorney/trustee to return the corpus of the trust.[132]

The consequences of having the trusts classified as grantor trusts are devastating to the Florida plan and the Texas proposal. Primarily, the accounting costs that a trustee/attorney would incur to determine and report the interest earned by each grantor/client would negate one of the premises of the concept. That premise is that an attorney will not incur any additional expenses by placing small quantities of clients' funds in savings accounts with the interest accruing to a third party. If an attorney did incur additional expenses, whether passed on to the client or absorbed by the attorney, one can imagine that attorneys would not participate in the plan and clients would not consent to the use of their money to enrich a third party at their expense.

No exceptions have been discovered whereby the trusts authorized by the plans could avoid being classified as grantor trusts. As will be discussed later in more detail, three alternatives may be available: first, amend the plans to function without the use of trusts; second, convince the Internal Revenue Service not to enforce the grantor trust provision; and third, request Congress to amend the Internal Revenue Code granting a special exemption to the type of trusts contemplated in the plans.

Assignment of Income. In the alternative, the Internal Revenue Service can be expected to allege that a client is liable under the assignment of

126. Treas. Reg. § 1.671-2(b) (1960).
127. *Id.*
128. *See* I.R.C. §§ 673-677.
129. *See id.* § 673(a).
130. *See id.* § 673(a).
131. *See id.* § 676(a).
132. *See id.* § 676(a).

income doctrine for the tax on the income earned by the trust. As a general rule, under the assignment doctrine income from property is taxable to the owner of that property.[133] The underlying theory of the doctrine of assignment of income, as stated in *Helvering v. Horst,*[134] is that the owner, or assignor, realizes income "because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants."[135] Although a taxpayer may never physically receive the income, either in the form of money or property, "realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has *already accrued* to him."[136]

Under the plan in Florida and the proposal for Texas, the client may be considered a taxable assignor because the client owns and controls the corpus of the trust by virtue of his power to revoke the trust at any time.[137] Furthermore, the client arguably controls the disposition of the earnings from the trust because diversion of the interest from the savings account to the Bar Foundation requires his specific consent.[138] A close evaluation of the principles of the assignment of income doctrine as defined in *Horst* may indicate that the facts surrounding the Florida and Texas plans are distinguishable.

Although a client under the plans may control the source of the income and even the disposition of that money, the client cannot receive any economic benefit or personal gain from his actions. The assignment of income doctrine is based on the premise that the assignor could have received the income from his investment and then expended the income, whether it be for the purchase of goods or the non-material satisfaction of making a gift to a charitable organization.[139] The very premise upon which

133. *See* Helvering v. Horst, 311 U.S. 112, 116-17 (1940).

134. *Id.* at 116-17.

135. *Id.* at 116-17.

136. *Id.* at 115 (emphasis added); *see* Comment, *Anticipatory Assignment of Income and the Person Taxable Under the Internal Revenue Code,* 5 DE PAUL L. REV. 290, 295 (1956). The horticultural metaphor often associated with the assignment of income doctrine is that the property of a taxpayer is a "tree" and the interest or earnings are the "fruit." Consequently, the only time a taxpayer can assign income without being taxed is when he relinquishes all control of the tree and fruit; the assignor's release of the fruit alone is not enough. *See* Estate of Smith v. Commissioner, 292 F.2d 478, 480 (3d Cir. 1961).

137. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 809 (Fla. 1978); TEX. REV. CIV. STAT. ANN. art. 317 (Vernon 1973); State Bar of Texas Code DR 9-102 (1973); Comment, *A Source of Revenue for the Improvement of Legal Services, supra* note 3 at 550, 555.

138. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 810-11 (Fla. 1978); Comment, *A Source of Revenue for the Improvement of Legal Services, supra* note 3, at 557.

139. *See* Helvering v. Horst, 311 U.S. 112, 117 (1940).

the Florida and Texas plans are based, however, negates the above premise concerning the assignment of income.[140] The plans are applicable to only those clients whose amounts of funds are so small that they cannot be invested to produce any economic gain.[141] "The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it *and enjoy the benefit of it when paid.*"[142] Given this statement of purpose, surely no one can seriously argue that the client should be taxed; the client would not have anything to enjoy because the attorney's fees would always, in theory, exceed any income earned. Although strong arguments can be made that the assignment of income doctrine is not applicable to the Florida and Texas plans, alternative approaches must be considered since the plans appear to fit squarely within the grantor trust sections of the Code.[143]

Trustee Must File Income Tax Return

The Florida plan and the Texas proposal could be devastated even without the Internal Revenue Service assessing the tax on the clients. An income tax return must be filed on every trust that received any taxable income or gross income of $600 or greater during the taxable year.[144] Although the trustee must file Form 1041, U.S. Fiduciary Income Tax Return,[145] and pay any income tax due by the trust,[146] he is usually not personally liable for that tax.[147] Nevertheless, if an attorney considering participation in the plan is required to file a fiduciary income tax return for each client's trust, his accounting costs will probably far exceed those accounting costs that would have been incurred if the attorney had simply left the client's funds in demand deposits. Consequently, it is doubtful that any attorney will elect to participate in a plan that will reduce his profits

140. Employing the horticultural metaphor often used in discussing the doctrine of assignment of income, the description of the plans is entirely different. Under the plans, the client/assignor owns the tree but that tree can bear no fruit for the client. If the client loans or assigns the tree to a third party, then the tree will bear fruit for the third party.

141. If the size of a client's funds is large enough to be invested economically, the attorney has a duty to invest the funds for the client. *See* Levin v. Commissioner, 355 F.2d 987, 990 (5th Cir. 1966) (applying Texas law); Moore v. Sanders, 106 S.W.2d 337, 339 (Tex. Civ. App.—San Antonio 1937, no writ).

142. Helvering v. Horst, 311 U.S. 112, 119 (1940) (emphasis added).

143. *See* I.R.C. §§ 671-679.

144. *See id.* § 6012(a)(4).

145. *See id.* § 6012(b)(4); W. HOFFMAN, 1979 ANNUAL EDITION WEST'S FEDERAL TAXATION: CORPORATIONS, PARTNERSHIPS, ESTATES AND TRUSTS 624 (1978).

146. *See* W. HOFFMAN, 1979 ANNUAL EDITION WEST'S FEDERAL TAXATION: CORPORATIONS, PARTNERSHIPS, ESTATES AND TRUSTS 624 (1978).

147. *See id.* at 624. If, however, a trustee distributes all the assets of a trust, thus rendering the trust unable to pay federal income taxes, the trustee will be held personally liable if he made the distribution when he was aware or should have been aware of the taxes payable. *See* Treas. Reg. § 1.641(b)-2(a)(1960).

or result in excessive charges to the trust for the attorney's trustee fees.

The problem, however, may be avoided if only one trust is established with the Bar Foundation acting as trustee and each participating attorney acting as agent for the trustee. As an agent for the trustee, each attorney could establish a trust savings account in a bank under the trustee's name. Not only would this procedure reduce the number of tax returns needed to be filed to only one, it would also place each attorney in the same position as if he were simply depositing clients' funds in demand accounts. The accounting requirements for the Bar Foundation as trustee would be minimal since the Foundation would already have been keeping records of interest received.

Possible Solutions

Interest-Free Loans. To eliminate the possible imposition of taxes and the need for preparing income tax returns, bar associations considering the concepts of the Florida plan may wish to classify the trust transaction as an interest-free loan. This classification, however, is subject to contest as the Internal Revenue Service refuses to recognize the majority of court decisions holding that interest-free loans do not produce income and are not subject to gift taxes. Interest-free loans have arisen in three different circumstances; among commonly controlled businesses,[148] among relatives,[149] and among corporations, stockholders, and employees.[150] In all three circumstances a distinct relationship exists that gives some reason for a shift in economic benefits;[151] no distinct relationship exists, however,

148. *See, e.g.*, B. Forman Co. v. Commissioner, 453 F.2d 1144, 1149 (2d Cir.), *cert. denied*, 407 U.S. 934 (1972); I.R.C. §§ 482, 483; Treas. Reg. § 1.482-2 (a)(1)(1968). Prior to 1968 the courts would not impute interest on interest-free loans between commonly held or related business organizations. *See* Crown v. Commissioner, 67 T.C. 1060, 1064-65 (1977), *aff'd*, 585 F.2d 234 (7th Cir. 1978); Smith-Bridgman & Co. v. Commissioner, 16 T.C. 287, 292 (1951); O'Hare, *The Taxation of Interest-Free Loans*, 27 VAND. L. REV. 1085, 1096-1101 (1974); *cf.* Tennessee-Arkansas Gravel Co. v. Commissioner, 112 F.2d 508, 510 (6th Cir. 1940) (commissioner's imputation on rent-free use of equipment overruled by court).

149. *See* Johnson v. United States, 254 F. Supp. 73, 77 (N.D. Tex. 1966); Crown v. Commissioner, 67 T.C. 1060, 1065 (1977), *aff'd*, 585 F.2d 234 (7th Cir. 1978). *But see* Blackburn v. Commissioner, 20 T.C. 204, 207 (1953); Rev. Rul. 73-61, 1973-1 C.B. 408; Hooton, *Gift Tax Analysis of Non-Interest Bearing Loans*, 54 TAXES 635, 638-40 (1976).

150. *See* Suttle v. Commissioner, 47 T.C.M. (P-H) ¶ 78,393 (1978) (interest-free loan from corporation to majority stockholder not income); Dean v. Commissioner, 35 T.C. 1083, 1087-90 (1961) (interest-free loan from corporation to sole stockholders not income), *nonacq.*, 1973-2 C.B.4; Brandtjen & Kluge, Inc. v. Commissioner, 34 T.C. 416, 447 (1960) (corporation regularly made interest-free loans to employees; no income taxed to corporation).

151. *Compare* B. Forman Co. v. Commissioner, 453 F.2d 1144, 1154-55 (2d Cir.), *cert. denied*, 407 U.S. 934 (1972) (on interest-free loans made by two independent corporations to third corporation owned jointly and equally, interest income imputed) *with* Johnson v. United States, 254 F. Supp. 73, 77 (N.D. Tex. 1966) (taxpayer made large loans to children) *and* Suttle v. Commissioner, 47 T.C.M. (P-H) ¶ 78,393 (1978) (interest-free loan from corporation to majority stockholders).

between a client and a bar foundation,[152] and no reason for a shift in economic benefits, if any exist, is apparent.[153] The following paragraphs briefly discuss each of the three circumstances in which interest-free loans have arisen, the distinction between each of these circumstances and the concepts of the Florida plan, and additional reasons why an interest-free loan between a client and the bar foundation should not be taxed as income or a gift.

Under Code section 482 the Internal Revenue Service is authorized to allocate income, deductions, credits, or allowances among commonly controlled businesses, incorporated and unincorporated "to prevent evasion of taxes or clearly to reflect the income of any of such organizations."[154] The Service has mechanically applied this section of the Code often favorably prosecuting cases to the United States Courts of Appeals when the Tax Court or district courts disagreed.[155] Certainly the relationship between a client and a bar foundation does not come within section 482. Furthermore, the Service would be hard pressed to prove a client was attempting to evade taxes when that client's funds could not even be economically invested for him; the Service must face "economic reality" when applying section 482 to interest-free loans.[156]

When interest-free loans are made between relatives, the Internal Revenue Service can be expected to assert a taxable gift has been made.[157] Taxpayers may counter, however, with two court decisions, one as late as September 1978, rejecting the reasoning of the Service's Revenue Ruling 73-61.[158] Both courts refused to impute interest, holding that interest arises

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152. *Cf.* [1979] STAND. FED. TAX REP. (CCH) ¶209.01 (citing I.R.S. Letter Ruling 7731007: interest-free loan between two unrelated businesses never contemplated to create liability for interest).

153. The Florida plan is based on the premise that a client cannot realize any economic benefit because the amount of his funds are so small and the period of time in which the funds are held by the attorney is so short that the funds cannot be invested economically. *See In re* Interest on Trust Accounts, a Petition of the Florida Bar, 356 So. 2d 799, 801 (Fla. 1978).

154. I.R.C. § 482.

155. *See, e.g.,* Liberty Loan Corp. v. United States, 359 F. Supp. 158, 164-65 (E.D. Mo. 1973), *rev'd,* 498 F.2d 225 (8th Cir. 1974); Kahler Corp. v. Commissioner, 58 T.C. 496, 510-12 (1972), *rev'd,* 486 F.2d 1, 4-5 (8th Cir. 1973); Kerry Inv. Co. v. Commissioner, 58 T.C. 479, 490 (1972), *aff'd in part, rev'd in part,* 500 F.2d 108 (9th Cir. 1974); O'Hare, *The Taxation of Interest-Free Loans,* 27 VAND. L. REV. 1085, 1099-1102 (1974).

156. *See* B. Forman Co. v. Commissioner, 453 F.2d 1144, 1156 (2d Cir.), *cert. denied,* 407 U.S. 934 (1972).

157. *See* Johnson v. United States, 254 F. Supp. 73, 77 (N.D. Tex. 1966); Crown v. Commissioner, 67 T.C. 1060, 1061-62 (1977), *aff'd,* 585 F.2d 234 (7th Cir. 1978); Rev. Rul. 73-61, 1973-1 C.B. 408.

158. Rev. Rul 73-61, 1973-1 C.B. 408. Under this ruling, the Service concluded section 2511 imposed a gift tax on interest imputed on loans between related parties when the interest on those loans was less than the fair market value interest rate. The Service's position under the ruling was that:

> The right to use property, in this case money, is itself an interest in property, the

from contractual obligations or statutes and that taxpayers have no requirement to invest their money for profit.[159] Under the client-bar foundation relationship, it is doubtful that the Internal Revenue Service will extend its contention that a taxable gift has been made. Furthermore, section 2503(b) of chapter 12, Gift Taxes, provides a $3,000 annual exclusion per person on gifts up to a maximum of $47,000 quarterly, per donor beginning January 1971.[160] Under the Florida plan and the Texas proposal, an attorney has a duty to invest funds for the benefit of the client long before the earnings could accumulate to $3,000.[161] Consequently, the Service will have nothing upon which to levy a tax.

In a third form of relationship among corporations, stockholders, and employees the Internal Revenue Service has consistently, but futilely, attempted to assess income taxes on interest-free loans. In *Dean v. Commissioner*[162] the Internal Revenue Service first assessed a tax on corporate stockholders who had received interest-free loans from their corporation.[163] The Service imputed income to the stockholders contending that the loan was in lieu of dividends and analogous to the "rent-free use of corporate property."[164] The Tax Court disagreed with the Service, reasoning that if the stockholders had borrowed money, the interest payments would have been deductible; in turn, this deduction would offset the imputed income, thereby resulting in no taxable income.[165] Although the decision in *Dean* has been criticized,[166] it has been consistently followed, most recently in October 1978.[167] If the Florida plan or the Texas proposal

> transfer of which is a gift within the purview of section 2501 of the Code unless full and adequate consideration in money or money's worth is received. The tax . . . would be imposed on the value of the right to use the money.

Id. at 409; *see* Hooton, *Gift Tax Analysis of Non-Interest Bearing Loans,* 54 TAXES 635, 635-37 (1976).

159. *See* Crown v. Commissioner, 585 F.2d 234, 240 (7th Cir. 1978); Johnson v. United States, 254 F. Supp. 73, 77 (N.D. Tex. 1966).

160. *See* I.R.C. §§ 2503(b) ($3,000 annual exclusion per person), 2505(a) ($47,000 quarterly maximum per donor).

161. See notes 89-91 *supra* and accompanying text for an explanation of when a client's funds should be invested for the benefit of the client.

162. 35 T.C. 1083 (1961), *nonacq.* 1973-2 C.B. 4.

163. *Id.* at 1083.

164. *Id.* at 1089.

165. *Id.* at 1090.

166. *See* O'Hare, *The Taxation of Interest-Free Loans,* 27 VAND. L. REV. 1085, 1095-96 (1974); Schlifke, *Taxing as Income the Receipt of Interest-Free Loans,* 44 TAXES 544, 546-47 (1966).

167. *See* Joseph Lupowitz Sons, Inc. v. Commissioner 497 F.2d 862, 868 (3d Cir. 1974) (interest-free loan did not create taxable constructive dividend to stockholders); Saunders v. United States, 294 F. Supp. 1276, 1282 (D. Hawaii 1968) (stockholders did not receive income when issued as interest-free loan), *rev'd on other grounds,* 450 F.2d 1047 (9th Cir. 1971); Suttle v. Commissioner, 47 T.C.M. (P-H) ¶ 78,393 (1978) (interest-free loan from corporation to majority stockholders not considered taxable economic benefit).

were to adopt an interest-free loan concept, the Internal Revenue Service would not attempt to extend its argument in *Dean* and other cases, since the recipient of the revenue, a bar foundation, would be a tax exempt organization.

As for imputing interest to a corporation for making interest-free loans to employees, the Internal Revenue Service has not contested any case since it acquiesced in 1960 to a ruling by the Tax Court.[168] In *Brandtjen & Kluge, Inc. v. Commissioner*[169] the Tax Court concluded that since the corporation never intended for employees to be liable for interest on the loans and that since the corporation followed this procedure for some time without ever collecting any interest, no interest income would be imputed to the corporation.[170] Under plans similar to that in Florida, although no employer-employee relationship would exist, the Service might possibly not assess a tax on the client if there were a specific agreement between the client and the bar foundation that there was no intention for the foundation to pay interest to the client.

Equitable arguments can be made for the Internal Revenue Service not to tax the client if plans similar to that in Florida are structured as interest-free loans. First, since a client could not recognize any economic advantage by requiring the investment of his funds for his benefit, it would be difficult for the Service to prove the client was avoiding taxes by allocating income to a bar foundation. Second, no substantial relation would exist between a client and bar foundation to indicate a subterfuge to avoid taxes. Third, a client would have no expectations of realizing a benefit from making a donation to a bar foundation.

Political and Legislative Solutions. The Idaho Bar Association has been considering implementation of a plan similar to that in Florida but has encountered a setback because the Internal Revenue Service contends that the clients must be taxed on the income earned on their funds.[171] In fact, the Idaho Bar Association, fearing a written adverse ruling, has recently withdrawn a request for an advisory letter from the Internal Revenue Service.[172] Although apparently inclined to tax the clients at this time, thereby destroying the plans, the Service is not beyond the reach of logic and the expression of overwhelming disfavor of taxpayers. If an organized effort by state and local bar associations to support the type of plan adopted by Florida is manifested, the Service might be willing to promulgate regulations specifically exempting income earned under the plans. Of course, if the Internal Revenue Service is deaf to the pleas of bar associations, then

168. *See* Brandtjen & Kluge, Inc. v. Commissioner, 34 T.C. 416, 447 (1960), *acq.* 1960-2 C.B. 4.

169. 34 T.C. 416 (1960).

170. *Id.* at 447.

171. *See* NAT'L L.J., March 26, 1979, at 10.

172. Telephone interview with John A. Boggs, State Bar of Florida (March 1979).

Congress should be requested to amend the Internal Revenue Code specifically exempting the income derived from plans similar to that in Florida from federal gift and income taxes.

CONCLUSION

The improvement of legal services to all citizens in the United States is a worthy and important goal. To date the factor that most limits the improvement of these services is money. The Florida Supreme Court has adopted a concept founded on the experiences of foreign countries that can produce substantial revenue to improve legal services; this comment recommends adoption of a similar plan for Texas. The concept provides that clients' funds that cannot be economically invested for the benefit of the clients and that would otherwise remain in non-interest-bearing accounts may be deposited in trust savings accounts to earn interest for the benefit of legal service programs.

The plan adopted by Florida and the concepts embodied within it and the Texas proposal face a severe challenge by the Internal Revenue Service. Not only has the Service prevented the funding of certain legal service programs, but it also may destroy the entire plan by seeking to tax clients, the parties who could never realize any income in the first place. Nevertheless, the Texas Bar Association should establish a committee to consider implementing a plan similar to that proposed in this comment. The most important action, however, that the Texas Bar Association can take at this time is to join with the Florida Bar in attempting to dissuade the Internal Revenue Service from assessing a tax on the interest earned for the benefit of public legal programs.