ADVANCED PLANNING

bulletin

January 2007

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The Tax Rationale for Paying Estate Taxes with Life Insurance

Michael R. Doucette
Attorney at Law
Atlanta, Georgia

Life insurance is often used to pay estate taxes. However, many who advise against using life insurance do not understand the tax reasons why life insurance is an ideal asset with which to pay estate taxes. The purpose of this article is to briefly analyze why this is true.

BACKGROUND

The federal transfer tax system is generally tax-inclusive. This means that when a person dies, estate taxes are levied on the total value of his property, including the property that will be used to pay the estate taxes.

The transfer tax system is *not* tax-inclusive, however, with respect to property transferred during life to the extent that the donor either: (a) qualifies the transfer for the annual gift tax exclusion, or (b) pays taxes on a taxable gift and lives three years after the date of the gift.

The fact that estate taxes are tax-inclusive has a very significant effect on the amount passing to beneficiaries.

To illustrate, suppose that Father wants to pass $3,000,000 to Son in 2011. (Note: All transfers in this article take place in 2011 because that is when the estate and gift tax systems will be reunified. Until then, the exemption applicable to gifts is $1,000,000. The estate tax exemption is higher. This differential introduces computational and conceptual difficulties that have no effect on the ultimate point of this article.). To accomplish this objective during life, Father needs $3,945,000. Specifically, he needs $3,000,000 to give to his son plus the gift taxes on a $3,000,000 transfer. (The gift taxes on a $3,000,000 taxable gift in 2011 will be $945,000. This example assumes that Father lives more than three years after the date of the gift.)

To transfer $3,000,000 to Son at death in 2011, Father's estate needs $5,100,000. (In 2011, the estate taxes on a $5,100,000 taxable estate will be $2,100,000. Thus, the estate would have $3,000,000 to distribute to Son after estate taxes are paid.)

In other words, Father would need approximately 29.3% more property to achieve his objectives for Son if he chooses to pay transfer taxes with property that is, itself, subject to transfer taxes. [($5,100,000 - $3,945,000/$3,945,000 = 29.3%)] The reason for this significant discrepancy is that, in the case of property transferred by gift, the gift taxes themselves are not subject to a transfer tax. However, in the case of property transferred at death, the estate taxes *are* themselves subject to that tax.

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IMPLICATIONS

The purpose of this example is not to make the case that Father should, during his lifetime, give $3,000,000 to Son. That would probably be undesirable for three reasons. First, Father would incur a cost of $3,000,000 to make the gift. Second, Father himself would be paying the tax. Third, it's unlikely that a person would voluntarily make a transfer that would result in the imposition of gift taxes in an atmosphere where it's possible that the transfer tax system will be abolished.

Rather, the point is that if a person is concerned about the amount of property his beneficiaries will receive, he should arrange for the payment of transfer taxes with property not subject to transfer taxes. Aside from paying gift taxes, the only means by which a person can pay transfer taxes with property not subject to those taxes is to give property away. The value of the transferred property can then be used to purchase assets from the decedent's estate.

One tax advantage of making gifts is that post-gift appreciation is removed from the gross estate. To the extent that gifts qualify for the annual gift tax exclusion, the property is completely removed from the donor's gross estate. This suggests that to maximize the transfer tax advantages of gifts, appreciating property should be transferred.

There is a tax disadvantage to making gifts. Specifically, the transferred property will not receive a "step-up" in basis under §1014. This disadvantage is particularly problematic when the property given away will be used to pay the estate tax. The transferred property will have to be converted to cash after death to pay the tax. Also note that the more the transferred property appreciates (which will maximize transfer tax benefits), the more costly the loss of the step-up in basis will be.

From a planning standpoint, the ideal asset to give away to pay transfer taxes will appreciate, will be easily convertible to cash, and will produce tax-free income (so that the loss of the step-up in basis will be immaterial). To this author's knowledge, life insurance is the only property that possesses all these characteristics. (The gain on municipal bonds that is attributable to market fluctuations in interest rates is not tax-free.)

When analyzing how to pay estate taxes, the factors discussed in this article should be considered. The point is not to suggest that life insurance is always the best asset with which to pay estate taxes. Rather, the points are that: (a) it makes sense to give away property to pay estate taxes and, (b) life insurance, and only life insurance, possesses those structural characteristics which make for an ideal gift under the Internal Revenue Code. Using life insurance to pay estate taxes should not be dismissed out of hand, rather it should often be considered at the top of the list of options.

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The Tax Relief and Health Act of 2006

President Bush signed the Tax Relief and Health Care Act of 2006 (Act) into law on December 20, 2006. As its name suggests, many provisions relate to health care, but there are others that extend or modify Code sections. The following are highlights of several of the provisions.

I. Extension of Certain Income Tax Deductions

A. Tuition and Education Expense Deduction

Background: Subject to adjusted gross income limits, taxpayers can deduct up to $4,000 of qualified tuition and related expenses at postsecondary education institutions (e.g. college, university, vocational school). § 222. The deduction was set to expire for tax years beginning after December 31, 2005.

Extension: The deduction is permanently extended.

Comment: Parents making too much money to claim the Hope and Lifetime Learning credits of § 25A may be able to take this deduction because it has higher income limits.

B. State and Local Sales Tax Deduction

Background: Taxpayers can elect to deduct state and local sales taxes instead of state and local income taxes. The deduction is either the actual amount of sales tax paid or an amount determined under I.R.S. tables plus the sales tax amount for motor vehicles, boats and other items specified by Treasury. § 164(b). The deduction was set to expire for tax years beginning after December 31, 2005.

Extension: The deduction is permanently extended.

Comment: Taxpayers who live in states without income taxes are most likely to take this deduction, but taxpayers in other states may benefit if they bunch purchases in one year so their sales tax exceeds their state income tax.

C. Availability of Archer Medical Savings Accounts (MSAs)

Background: MSAs are tax-exempt trusts in which a person can save money to pay medical expenses. MSAs are only available to self-employed persons or employees of small businesses who purchase high deductible health insurance policies. Contributions to MSAs are deductible up to a percentage limit of the annual deductible. § 220. As a pilot program, the cut-off for creating new MSAs was initially 2003, but it was extended to the end of 2005.

Extension: The cut-off for creating new MSAs is the end of 2007.

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Comment: Although MSAs have been around longer, Health Savings Accounts (HSAs) and Health Reimbursement Accounts (HRAs) are more widely-used vehicles for saving for medical expenses.

II. Health Savings Accounts (HSAs)

HSAs, like MSAs, are tax-exempt trusts in which a person with a high deductible health insurance policy can save money to pay medical expenses. However, HSAs are not subject to the same restrictions as MSAs and other health savings arrangements. For more information on HSAs, see When an Apple a Day Doesn't Keep the Doctor Away, *Advanced Planning Brief* No. 57 (April 2004).

A. FSA and HRA Rolled into HSAs

Old Law: None.

New Law: An employee's entire Flexible Spending Account (FSA) or HRA can be rolled over in a one-time tax-free distribution to a HSA. For the twelve months following the distribution, the employee must own a high deductible health insurance policy to avoid income taxes and a penalty on the distribution. See § 223(c). The amount distributed is limited to the lesser of the FSA or HRA account balance as of September 21, 2006, or as of the date of the distribution. The distribution must be made by the employer and is available until January 1, 2012.

Effective Date: Applies to distributions on or after December 20, 2006.

Comment: The additional funding options are a nice touch, but the limits on frequency (one-time transfer) and amount (frozen as of September 21, 2006 or less) don't create much of an opportunity to sock away money.

B. IRA Distributions to Fund HSAs

Old Law: None.

New Law: HSAs can be funded with a one-time tax-free distribution from an IRA. The amount distributed is generally limited to the annual contribution amount for HSAs. See C. below and § 223(b). Similar to the provision for rolling over FSA or HRA amounts, an IRA owner must own a high deductible health insurance policy for twelve months following the distribution to avoid income taxes and a penalty on the distribution, and the amount distributed must be transferred directly from the IRA. Unlike the FSA and HRA provision, a distribution from an IRA is considered a contribution that counts toward the annual HSA contribution limit.

Effective Date: Applies to taxable years beginning after December 31, 2006.

Comment: Like the FSA and HRA provision, this provision won't be a big deal for many taxpayers because of the once-a-lifetime and the dollar limitations. However, it is a nice funding option for those desperately searching for cash to contribute to their HSAs.

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C. Deductible Contribution Limits

Old Law: Deductible contributions to HSAs are based on a monthly limit which is the lesser of 1/12 of:

- $2,250 ($2,850 in 2007) for individual coverage or $4,500 ($5,650 in 2007) for family coverage, or
- the annual deductible under the health insurance policy.

New Law: The monthly limit for deductible contributions is 1/12 of $2,250 ($2,850 in 2007) for individual coverage or $4,500 ($5,650 for family coverage). The part of the formula related to the annual deductible is eliminated.

Effective Date: Applies to contributions made in taxable years beginning after December 31, 2006.

D. Cost of Living Adjustment

Old Law: The minimum deductible, contribution limits, and out-of-pocket limits for HSAs are indexed for inflation. The inflation adjustments are based on the Consumer Price Index as of August 31 of each year. §§ 1(f)(4) and 223(g).

New Law: The inflation adjustments will be based on the Consumer Price Index as of March 31 and announced by June 1 of each year.

Effective Date: Applies to taxable years beginning after 2007.

Comment: This is a change that is sure to make end of the year planning less hectic for employers and employees alike.

E. Partial Year Eligibility

Old Law: An individual who became eligible to contribute to a HSA during a year could only deduct a prorated amount of the annual limit based on the full number of months of eligibility. § 223(b).

New Law: An individual who becomes eligible to contribute to a HSA during a year will be treated as being eligible for the entire year. However, if the individual does not maintain eligibility for twelve months following the end of this period, additional income and taxes result due to the contribution not being deductible.

Effective Date: Applies to taxable years beginning after December 31, 2006.

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F. Comparable Contributions

Old Law: An employer must make comparable contributions to all employees' HSAs. §§ 4980E and 4980G.

New Law: An employer can contribute more to a HSA of an employee who is not highly compensated (as defined in § 414(q)) than to an employee who is highly compensated without violating the comparable contribution rule.

Effective Date: Applies to tax years beginning after December 31, 2006.

Comment: Perhaps the only reason it's better not to be highly compensated?

III. Miscellaneous

A. Frivolous Tax Submission

Old Law: Filing a frivolous income tax return resulted in a $500 penalty. § 6702.

New Law: The penalty for filing frivolous tax submissions is $5,000. Treasury will issue a list of positions deemed to be frivolous. Taxpayers have an opportunity to contest frivolous submissions in a hearing.

Effective Date: Applies after the date on which Treasury issues its frivolous position list.

Comment: The stakes continue to rise in the tax shelter game, but is a $5,000 penalty really enough to get anyone's attention?

B. Unrelated Business Taxable Income

Old Law: A charitable remainder trust is exempt from income tax unless it has unrelated business taxable income (UBTI). § 664(c). Consequently, any amount of UBTI results in *all* the trust's income being taxed.

New Law: A charitable remainder trust with UBTI is taxed on just that amount of income. All other income remains exempt from income taxation.

Effective Date: Applies to taxable years beginning after December 31, 2006.

Comment: Most charitable remainder trusts do not invest in assets that generate UBTI; however, this is welcome relief from the dire "all or nothing" result of the old law and may give CRT trustees more investment options.

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C. Credit for Previously-Paid Individual AMT Made Refundable

Background: Under § 53, the alternative minimum tax (AMT) paid by an individual or corporation can be taken as a credit against regular income taxes in future years. However, for individuals, the credit does not include all AMT liability. For example, it does not include AMT attributable to state and local property taxes, tax-exempt interest, and several other exclusion preferences. In addition, many individual and corporate taxpayers never benefit from this credit because it can only be taken against the "excess" regular tax liability above the minimum tax in a given year.

Old Law: This credit was only available to offset the taxpayer's regular tax in excess of the taxpayer's AMT.

New Law: Under § 53(e), this credit is a *refundable* one for individual taxpayers by making it available regardless of the taxpayer's current regular income tax. This means that a taxpayer could use the credit against regular tax, or even receive funds back from the I.R.S., in situations where the credit was previously unavailable.

But here's the fine print! The refundable credit only applies to "long-term unused" AMT credits, which are defined as those applicable to tax years more than three years before the current tax year. It is phased out at high incomes and, under the best case scenario, is limited to 20% of the long-term unused amount.

The new provision assumes that credits are taken on a first-in, first-out basis. If a taxpayer has credits accumulated over several years, the oldest credits are tapped first when applying the three-year test .

Effective Date: The refundable credit can be taken beginning with the 2007 tax return; it expires in 2013.

Comment: This is a narrow provision that purportedly was intended to benefit owners of incentive stock options, who are subject to an AMT calculation on the option spread at exercise. If you think Congress is serious about AMT reform, think again.

The corporate AMT is not affected by this provision.

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All in the Family: The IRA Aggregation Rule of § 408(d)(2)

There has been a lot of hype in the IRA world about the loosening of eligibility requirements to convert a traditional IRA to a Roth IRA coming in 2010. See To Convert or Not to Convert (Traditional IRA to Roth IRA) That is the Question: Here is the Answer, *Advanced Planning Bulletin*, December, 2006, and Tax Increase Prevention and Reconciliation Act of 2005, Highlights of the Act, *Advanced Planning Bulletin*, June 2006. The important points to know about these changes are:

- Starting in 2010, conversions are available to everyone, regardless of filing status and regardless of AGI (currently, conversions are not available to those with AGI over $100,000 or to married filing separately taxpayers).
- For conversions in 2010, the taxable income resulting from a conversion can be spread equally between 2011 and 2012.

If conversion makes sense for a client, then, to get more of a good thing, it's smart to put as much as possible now into a traditional IRA for conversion in 2010 or later. Ways to load up on a traditional IRA include:

- Maximize contributions.
- Roll funds from qualified retirement accounts.
- Make nondeductible contributions.

Upon conversation, the amount in the IRA, less any basis, is taxable. It is a well-known fact – as least among tax nerds – that nondeductible contributions create basis in an IRA. Basis is good because conversions of basis are not taxable income.

What is not as well-known is the aggregation rule. In the I.R.S.'s eyes, a client only has one IRA, even if the client actually has several different accounts. And, since there is only one IRA, there is only one basis. Contrary to ideas touted as the new IRA planning strategy, a client *cannot* pick and choose which account to convert in hopes of using an account that has more basis. Here's an example:

> Client has $500,000 in IRA #1 with no basis and $250,000 in IRA #2 with $100,000 of basis. In 2010, Client converts IRA #2, mistakenly thinking that he will only have $150,000 of taxable income. Since this is viewed as one $750,000 IRA with $100,000 of basis, Client can only allocate $33,333 of his basis to the conversion, resulting in $216,667 of taxable income.[1]

If the client's objective is to maximize the amount to convert, regardless of the fact that the entire balance (less basis) will be taxable, then making nondeductible contributions to a traditional IRA is an appropriate strategy. But be wary of strategies urging clients to load up on nondeductible contributions in one IRA so that they can convert that account and take advantage of the basis in that one account – the I.R.S. doesn't see it the same way!

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[1] Calculation of basis allocated to the conversion: ($100,000 ÷ $750,000) x $250,000 = $33,333. See I.R.S. Form 8606.

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Employer Stock in a 401(k) Plan: What Retirees Should Know about Net Unrealized Appreciation

Edgar has been a marketing executive at Clover, Inc. since 1986 and is now, at the age of 65, retiring. Always a diligent saver, Edgar has $1.5 million in his 401(k), including $800,000 of Clover stock. He wants to know what, if anything, he should do with his account. Edgar also says that, as he heads into retirement, he wants to shift to conservative investments so he doesn't lose everything if the stock market goes down. The Clover stock represents a big portion of his savings and he wants to sell some of it, particularly now that he will no longer be working for Clover. And no surprise here – he also wants to minimize taxes.

1. Do Nothing

Edgar may have the option of doing nothing if his 401(k) plan allows him to keep his account after retirement, and most do. However, he will eventually have to take required minimum distributions from the plan; doing so will prevent him from being eligible for NUA treatment (discussed below).

2. Rollover to IRA

Edgar knows about IRA rollovers and always assumed he would do one. This involves transferring assets from his 401(k) account to an individual retirement account (IRA). This will delay taxation until the assets are distributed from the IRA. IRA distributions will be taxable at ordinary income tax rates. An IRA rollover may offer Edgar additional benefits, including increased investment choices and lower expenses.

3. NUA – A Better Way

Not so fast, Edgar. Better stop and re-think that Clover rollover. There is a way to avoid paying ordinary income tax on the full value of the Clover stock. Although distributions from a 401(k) are normally entirely taxable, Edgar can take an outright distribution of the Clover stock and elect to pay ordinary income tax on only the 401(k)'s basis in that stock. The appreciation in the Clover stock existing at the time of distribution ("net unrealized appreciation" – NUA) will only be taxed when the stock is later sold and then at the long-term capital gain rate – currently 15%. In addition, post-distribution appreciation will also be long-term capital gain if the distributed stock is held for more than 12 months.

So, if Edgar acts on his initial instinct and does an IRA rollover, he will lose the ability to be taxed on the NUA at 15%. Instead, all IRA distributions will be taxed at his marginal rate, which is currently 35%. The following chart illustrates the disparate tax treatment:[2]

[2] Assumptions: 35% ordinary income tax rate, 15% capital gain rate, and 7.2% growth rate.

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	NUA Distribution	IRA Rollover
Value of Stock	$800,000	$800,000
Cost Basis	$300,000	$300,000
Tax Owed	$105,000	$0
Additional Tax	$10,000[3]	$0
Balance	$685,000	$800,000
Future Value in 10 Years	$1,370,000	$1,600,000
After-Tax Value	$1,209,500[4]	$1,040,000

According to these assumptions, Edgar will be $169,500 ahead with the NUA distribution.

What About the Other 401(k) Assets?

Regardless of what he decides to do with the Clover stock, he also needs to consider what he will do with the rest of his 401(k) – the $700,000 that is not invested in Clover stock. To be eligible for NUA treatment, the 401(k) account must be distributed as a "lump sum distribution," which means that the entire account – Clover stock and the other assets – must be distributed in one tax year. Fortunately, the I.R.S. has ruled that as long as the entire account is distributed from the 401(k), an employee can roll part of the distribution to an IRA without jeopardizing the NUA tax treatment on the non-rolled portion.[5]

What's the Stock's Basis?

The 401(k)'s basis in the Clover stock before distribution dictates the tax benefit of NUA. The higher the basis, the lower the NUA, and less will be taxed at the 15% rate. For instance, if the basis were $750,000 instead of $300,000, the NUA Distribution After-Tax Value would be computed as follows:

	NUA Distribution
Value of Stock	$800,000
Cost Basis	$750,000
Tax Owed	$299,500[6]
Balance	$500,500
Future Value in 10 Years	$1,000,000
After-Tax Value	$962,500[7]

[3] This presumes that Edgar will sell additional stock to help him pay the tax owed, thereby resulting in additional tax. ($800,000 value of stock - $300,000 cost basis) / ($800,000 value of stock) = (.625) x ($105,000 tax owed) x (15% tax rate) = $9,843.75 (rounded up to $10,000 for purposes of this calculation).

[4] $1,370,000 - $300,000 (tax basis) = $1,070,000 (gain) x 15% (tax rate) = $160,500 (tax). $1,370,000 - $160,500 = $1,209,500.

[5] Priv. Ltr. Ruls. 2003-15-041 (April 11, 2003), 2002-02-078 (January 11, 2002), 2000-38-050 (September 25, 2000), and 1999-19-039 (May 17, 1999).

[6] $750,000 x 35% tax rate = $262,500 + (($750,000 cost basis / $800,000 value of stock) x ($262,500) x (15% tax rate)) = $299,414.06

[7] $1,000,000 - $750,000 (tax basis) = $250,000 (gain) x 15% (tax rate) = $37,500 (tax). $1,000,000 - $37,500 = $962,500.

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Under these altered facts and using the same assumptions, the IRA rollover of his entire account, including the Clover stock, looks better.

There's More to this Story than Tax

The numbers will change if Edgar has any basis in the 401(k) account (*i.e.*, after-tax contributions) or if Edgar were subject to any 10% early withdrawal penalty – he isn't under our facts here. However, keep in mind that the decision to make an NUA election isn't just based on numbers. In addition to tax considerations, the decision turns on the level of investment risk Edgar is willing to stomach. Edgar said he wanted to own less Clover stock. If he plans to sell it immediately, he may decide to do an IRA rollover; liquidating the Clover stock in the IRA does not result in any income taxes whatsoever and the proceeds can then be re-allocated within the IRA as he wishes.

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Yet More Tax Shelter Regulations Call For Overview of the Rules: Final and Temporary Regulations: T.D. 9295 (November 1, 2006); Proposed Regulations: REG-103038-05, REG-103039-05, and REG-103043-05

Background: Keeping up with the law of tax shelters can be exhausting. Not only are there multiple provisions applying separately to promoters, taxpayers, and practitioners, but Congress and Treasury issue new rules even before the ink is dry on the old ones.[8] The resulting patchwork leaves honest taxpayers confused and scammers sniffing out loopholes. The latest changes (November 2006) come in the form of regulations designed to carry out statutory amendments created in late 2004 by the American Jobs Creation Act.[9] To help keep it all straight and in one place, here's a rundown of the current law.

Rules applying to tax practitioners – Circular 230: The rules governing tax practitioners – attorneys, accountants, and some others – are found in 31 U.S.C. § 330 and its regulations (known as Circular 230). As we described in the past, these provide potentially onerous standards for written tax opinions, and failure to meet the requirements can bring disbarment from practice before the I.R.S. and monetary penalties.[10] The noble intent is to curtail the production of canned tax opinions that are designed solely to give investors a defense to underpayment penalties. Unfortunately, Circular 230's reach is so ambiguously broad it might ensnare purely educational materials – like this Bulletin – and it can force practitioners to write things that are not always true (*e.g.*, stating that "this opinion cannot be relied on to avoid penalties" whenever it doesn't contain a more-likely-than-not conclusion level – when in reality that is not what's required by the penalty defense regulations).

Rules applying to promoters (material advisors) – §§ 6111, 6112, 6707, and 6708: Sections 6111, 6112, 6707 and 6708 apply to tax shelter promoters, who are now called "material advisors." These statutes cast a wide net, as they cover anyone who makes a minimum amount of compensation and provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out a "reportable transaction" (more on this term below).[11] By statute, the minimum compensation amount is $50,000 if the benefited taxpayers are natural persons and $250,000 otherwise, but proposed regulations reduce these threshold amounts to $10,000 and $25,000 for "listed transactions" (more on this term below too).[12]

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[8] For example, recent legislation regarding tax shelters came in the American Jobs Creation Act of 2004 and the Tax Increase Prevention and Reconciliation Act of 2005 (signed in May 2006). Recent Treasury pronouncements came in Notice 2004-80, 2004-2 C.B. 963; Notice 2005-17, 2005-1 C.B. 606; Notice 2005-22, 2005-1 C.B. 756; and Notice 2006-6, 2006-5 I.R.B. 385 (January 6, 2006).

[9] The final and temporary regulations in T.D. 9295 are effective November 1, 2006; the proposed regulations will be effective once they are published as final.

[10] See Brief Summaries in *Advanced Planning Bulletin*, March 2006 (discussing REG-122380-02 (February 2, 2006)) and You're Entitled to Your Opinion (Kinda) – Final Circular 230 Regulations on Tax Opinion Standards: Treasury Decision 9165 (December 17, 2004) and Treasury Decision 9201 (May 18, 2005), *Advanced Planning Bulletin*, July 2005.

[11] § 6111(b).

[12] See § 6111(b)(1)(B) and Prop. Reg. § 301.6111-3(b)(3)(i). Apparently, Treasury feels permitted to lower the threshold amounts based on its authorization to issue regulations "as may be necessary or appropriate to carry out the purposes of this section." § 6111(c)(3).

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Material advisors must file an informational return with the I.R.S. that describes the reportable transaction,[13] and failure to do so triggers a penalty of $50,000, or at least $200,000 if it is a listed transaction. The material advisor also must keep a list of participants and provide those names to the I.R.S. within 20 days after a request or face a penalty of $10,000 per day.[14]

All this should give those who buy into aggressive schemes more reason to worry. Even though the chances of the I.R.S. auditing you initially might be slim, they are going to audit someone. If any of these other unlucky souls have purchased the same plan from the same material advisor as you, the material advisor will have to share the paper trail that leads to your doorstep.

Rules applying to taxpayers (disclosures on the front end) – §§ 6011 and 6707A: Section 6011 gives Treasury the discretion to decide what information is required on tax returns, and Treasury has exercised this authority to require that taxpayers disclose participation in any one of six types of "reportable transactions:"[15]

1. Listed transaction. This vilified arrangement includes anything that is the same as or substantially similar to those identified by the I.R.S. as being "tax avoidance transactions."[16]

2. Transaction of interest. The November 2006 proposed regulations introduce this new class to replace the "book-tax difference" category, and the preamble describes this as whatever the I.R.S. believes has "a potential for tax avoidance or evasion." Essentially, these are suspected of being listed transactions, but the government just doesn't know enough about them yet.

3. Confidential transaction. This exists when an advisor who is paid a minimum fee limits the taxpayer's right (regardless if legally enforceable) to disclose the arrangement's tax treatment or structure.[17] The minimum fee is $250,000 if the taxpayer is a corporation and $50,000 otherwise. Fees include consideration in any form to implement, advise on, or document the transaction; the proposed regulations warn about the I.R.S. carefully scrutinizing this area, so sales commissions are probably counted.[18]

4. Contractually protected transaction. This occurs if the taxpayer is given protection against the possibility that the tax benefits will be denied through refundable or contingent fees.

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[13] Disclosure will soon be made on Form 8918, "Material Advisor Disclosure Statement," which replaces Form 8264 and is filed with the Office of Tax Shelter Analysis.

[14] See §§ 6707(b) and 6708(a) and The American Jobs Creation Act of 2004 and the Working Families Tax Relief Act: A Selective Review, *Advanced Planning Bulletin*, November 2004.

[15] Both the existing final regulations and proposed regulations are in Treas. Reg. § 1.6011-4(b). Disclosure is made on Form 8886, "Reportable Transaction Disclosure Statement."

[16] The latest cumulative itemization of "listed transactions" appears in Notice 2004-67, 2004-41 I.R.B. 600 (September 24, 2004).

[17] Claiming that a transaction is proprietary or exclusive is not treated as a limitation on disclosure if the advisor tells the taxpayer that he can disclose it (implying that *failure* to give permission to disclose a claimed proprietary plan does trigger this category).

[18] Prop. Reg. § 1.6011-4(b)(3)(iv).

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5. Loss transaction. This happens whenever a taxpayer claims a loss under § 165 exceeding a minimum dollar amount in one year, or a higher minimum amount over six years: generally, $10 million/$20 million for C corporations and $2million/$4 million for other taxpayers.

6. Brief asset holding period transaction. This involves claimed tax credits over $250,000 where the taxpayer held the underlying asset for 45 days or less.

Taxpayers who comply with these rules presumably flag themselves for audit. This may prompt some to "forget" to tell the I.R.S., but failure to do so brings brutal penalties: $10,000 for a natural person and $50,000 for other taxpayers. These amounts shoot up to $100,000 and $200,000 if it is a listed transaction.[19] Talk about a rock and hard place.

These provisions also have a wider reach than they first appear. Anything "substantially similar" to a listed transaction is treated as if it were one. Not only is the term to be construed broadly – it can even cover transactions under other Codes sections – but a legal opinion saying it is not substantially similar is irrelevant.[20] If a taxpayer gets out of an arrangement before it becomes a listed transaction, he still has to disclose it if the statute of limitations has not yet expired for the years he benefited from it.[21] And individual taxpayers shouldn't think they are allowed to keep quiet just because it is their business that entered into the transaction and not them personally. For all reportable transactions, the participating taxpayer includes anyone whose return reflects the "tax benefits" of the arrangement, and this includes exclusions from income.[22] This should concern anyone whose employer is providing disguised deferred compensation or dividends through a purported welfare benefit plan.[23]

Lastly, final and temporary regulations have ended the ability of taxpayers and material advisors to postpone the due date for disclosure while seeking a private letter ruling about whether the arrangement is a reportable transaction.[24] Filing "protective disclosures" is still allowed for those who don't want to concede that their transaction is reportable, but proposed regulations clarify that the same detailed information is required, so it is unclear what it protects.[25]

Rules applying to taxpayers (penalties on the back end) – §§ 6662, 6662A, 6663, and 6664: For some taxpayers and too many promoters, the crux of tax planning comes down to one crude question: "so even if I get caught, can I still avoid penalties?" Here again, the rules have been tweaked over the last few years.

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[19] § 6707A(b).

[20] Prop. Reg. § 1.6011-4(c)(4) adds the statement about substantially similar transactions potentially including those under other Code provisions, but otherwise the existing final regulation provides the same.

[21] See both final and proposed Treas. Reg. § 1.6011-4(e).

[22] See both final and proposed Treas. Reg. § 1.6011-4(c)(6).

[23] Plans purporting to provide deductible contributions for welfare benefits by meeting the § 419A(f)(6) exception to the limits of §§ 419 and 419A are generally listed transactions. Also see *Neonatology Assoc. v. Comm'r*, 299 F.3d 221 (3d Cir. 2002), where the court recharacterized the employer's deductions for contributions to a welfare benefit plan as nondeductible dividends and currently taxable to the business owners.

[24] Treas. Reg. §§ 1.6011-4T(f) and 301.6111-3T(h).

[25] Prop. Reg. §§ 1.6011-4(f)(2) and 301.6111-3(g).

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1. Underpayment Penalties: Section 6662(a) imposes a 20% accuracy-related penalty to any portion of a tax underpayment – that's 20% of the unreported tax, not of the unreported income – which is attributable to any one or more of the following:

   - negligence or disregard of rules or regulations;
   - any substantial understatement of income tax;
   - any substantial valuation misstatement under chapter 1 (normal taxes and surtaxes);
   - any substantial overstatement of pension liabilities; or
   - any substantial estate or gift tax valuation understatement.[26]

   Section 6662A provides an alternative penalty for "reportable transaction understatements," which are those due to a (i) listed transaction or (ii) a reportable transaction for which tax avoidance or evasion is a significant purpose. How to determine when a reportable transaction also has a tax avoidance purpose – or why that wouldn't make it a listed transaction – is unclear. The penalty is triggered even if the understatement is not substantial. The understated income amount is multiplied by the highest tax rate (35% for individuals), and the additional penalty is 20% of that product (it's increased to 30% if the transaction was not disclosed under § 6011).

   If the understatement is due to fraud, § 6663 applies instead to impose a 75% penalty on the underpayment.

2. Defenses to Penalties: Under §§ 6662(d) and 6664, taxpayers can avoid penalties by having:

   - substantial authority for the position (an objective inquiry; taxpayer belief is irrelevant);
   - a reasonable basis for the position and adequately disclosing the relevant facts; or
   - a reasonable cause for an understatement and acting in good faith.[27]

   The first two defenses are unavailable for "tax shelters" (a term rarely used in the Code anymore) which here means any arrangement where "a significant purpose . . . is the avoidance or evasion of Federal income tax."[28] Deciphering the precise meaning of this phrase is largely guesswork, partly because the regulations still reflect the old "principal purpose" version of the statute. Determining reasonable cause and good faith also suffers from out-of-date regulations, but they state that the most important factor is the taxpayer's effort to assess true tax liability. Getting a legal opinion has never been required to show good faith, but it has never been automatically sufficient either, and courts are particularly suspicious of opinions provided by the promoter.[29]

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[26] For a more complete explanation of these provisions, see Tax Underpayment Penalties, Their Defenses, and Whether A Plan Promoter's Legal Opinion Really Protects You, *Advanced Planning Bulletin*, October 2004.
[27] Id.
[28] § 6662(d)(2)(C).
[29] See Treas. Reg. § 1.6664-4(b)(1), (c) and (f)(2)(B). Also see *Neonatology Assoc. v. Comm'r*, 299 F.3d 221 (2002), at n. 22; and *Heckler v. Comm'r*, T.C. Memo 1998-49 (1998), *citing Gollin v. Comm'r*, T.C. Memo 1996-454 (1996) and *Goldman v. Comm'r*, 39 F.3d 402 (2d Cir.1994), *affg*. T.C. Memo 1993-480.

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For reportable transaction understatements, § 6664(d) makes demonstrating reasonable cause and good faith more difficult. There must be adequate disclosure per § 6011, substantial authority for the position, *and* the taxpayer must reasonably believe that his treatment was more likely than not the proper treatment. Again, the taxpayer is not required to get a tax opinion to establish this belief, but if he wants to use one, he is barred from relying on an opinion that does not meet the Circular 230 requirements or that comes from someone paid directly or indirectly by a material advisor.

Final Thoughts:

1. Significant Purpose of Tax Avoidance. A persistent sin of the various tax shelter rules is the demonization of plans that have mere "tax avoidance" as a "significant purpose." Historically, tax *evasion* was a pejorative, but not simple *avoidance*. What's worse, the phrase is either left undefined or is described so sweepingly that it could cover nearly anything. Circular 230 states that being in line with a statute's intent protects a plan from having a *principal* purpose of tax avoidance, but this implies that such a plan could still have tax avoidance as a *significant* purpose.[30] Taken literally, this could cover innocent transactions like contributions to IRAs, gifts to charities or 1035 exchanges. It's time for the government to rein in this nonsense.

2. Don't Be Greedy. Some people are drawn to juicy tax schemes like moths are to a flame, but as we all know, they just get burned. To learn from the missteps of others, take a look at a couple cases involving Xelan, a now bankrupt promoter that used to advertise a smorgasbord of tax-deductible plans. The doctors who invested in Xelan's 419 and 412(i) arrangements claim they lost their investments and were left with little more than back taxes and penalties.[31] And there's no certainty that suing the marketer will make the client whole. Remember the *Neonatology* case, where the court skewered a VEBA welfare benefit plan and hit the taxpayer with penalties despite the promoter-provided legal opinion? Well, those duped clients sued just about everybody but were left holding the bag because the court said their claims were barred by the statute of limitations.[32]

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[30] 31 C.F.R. § 10.35(b)(10).

[31] *Kennard, et al. v. Indianapolis Life Insurance Co., et al*, 420 F.Supp. 2d 601 (N.D. Tex. 2006); and *Vig v. Indianapolis Life Insurance Co., et al.*, 366 B.R. 279 (S.D. Miss. 2005).

[32] *Cetel et al. v. Kirwan Financial Group, Inc.*, 460 F. 3d 494 (3d Cir. 2006).

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Reporting and Wage Withholding for Nonqualified Deferred Compensation Plans

Notice 2006-100, 2006-51 I.R.B. 1109 (December 1, 2006)

The I.R.S. provides interim guidance on reporting and wage withholding for amounts that are subject to § 409A. Among other things, the Notice:

- suspends information reporting on plan deferrals for 2005 and 2006;
- outlines reporting and withholding rules for § 409A *violations* that occurred during those years;
- states a method for determining the wage withholding "date" for amounts actually or constructively received in 2006; and
- provides separate guidance for plan participants who are not employees (*e.g.*, independent contractors).

It supersedes prior Notice 2005-94 and modifies Notice 2005-1.

Observations:

- These rules only apply to deferrals that are subject to § 409A, although "new" deferrals into "old" plans that trigger the Notice's requirements will require retroactive tracking by employers. This problem will become more acute when the information return requirement becomes effective.
- The requirements for reporting (as opposed to withholding) apply equally to service providers and service recipients. This means that employees and independent contractors should check whether the proper procedures are being performed, because any error can be held against the reporting taxpayer. In extreme cases involving large deferrals, it may be advisable to hire separate counsel to review the plan along with subsequent plan administration and reporting.

Charitable Contributions Made Through Payroll Deductions

Notice 2006-110, 2006-51 I.R.B. 1127 (December 1, 2006)

Effective for tax years beginning after August 17, 2006, a taxpayer's cash, check or other monetary contribution to a charity (regardless of amount) will not qualify for an income tax deduction unless the taxpayer maintains a bank record of the donation or a written communication from the charity showing the name of the charitable organization with the date and the amount of the contribution. § 170(f)(17).

For all contributions made by payroll deduction, the written communication requirement is met if (1) a W-2, pay stub or other document furnished by the employer includes the amount withheld for payment to the charity *and* (2) a pledge card or other document prepared by the charity shows the name of the charity. For each contribution of $250 or more made by payroll deduction, the

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pledge card or other document furnished by the charity must also include a statement that the charity does not provide goods or services in consideration for the donation.

Demutualization
Fisher v. U.S., 98 A.F.T.R., 2d 2006-7807 (November 15, 2006)

Trust buys a participating life insurance policy from a mutual life insurance company. Subsequently, the insurance company votes to convert to a stock company. As part of the demutualization, Trust receives shares of stock in the company. Trust then sells those shares and reports the proceeds, unreduced by any basis adjustment, as taxable income. Then, Trust files a refund claim, initially arguing that the sale proceeds should be deemed a policy dividend that is excluded from income to the extent of investment in the policy. Consistent with other demutualization rulings, the court disagrees. It rules that the proceeds are received under an unrelated sale of stock. Next, Trust argues there is no capital gain on the sale because the proceeds are offset by Trust's basis in the stock that carries over in the tax-free reorganization of the company. While the I.R.S. concedes that there is carryover basis, it argues that the amount is zero. The court refuses to rule on the basis issue, leaving the issue to be decided in a future trial. Stay tuned to see if Trust can successfully argue that there is basis where other taxpayers have had no such luck.

Qualified Plan Conversions
Notice 2007-6, 2007-3 I.R.B. (December 21, 2006)

The conversion of traditional qualified defined benefit plans to cash balance plans (sometimes called hybrid plans) was quashed by several courts that ruled these conversions discriminated in the way it affected older employees. These court rulings were the main reason the I.R.S. stopped issuing determination letters approving conversions. Consequently, employers who continued to convert were on their own, subjecting the plan to potential disqualification and risking the loss of income tax deductions. The Pension Protection Act of 2006 established rules that, if followed, would eliminate the discriminatory treatment of older employees, clearing the way for safer conversions. This Notice provides that the I.R.S will begin to process determination letters for conversions after June 29, 2005.

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- To comply with Circular 230

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