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See Circular 230 disclosure at the end of this article.

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Time to Report Employer–Owned Life Insurance Policies; Here's How: Form 8925

The Pension Protection Act was signed into law on August 17, 2006. It requires that employers annually report information about certain employer-owned insurance policies on employees. § 101(j); see *Advanced Planning Letter* No. 181 (September 2006). Until now, employers have had no guidance on these reporting requirements.

Employers owning any insurance issued after August 17, 2006 on the lives of employees must file Form 8925 for tax years ending after November 14, 2007. The half-page form reports:

- The number of employees at the end of the tax year.
- The number of insured employees at the end of the tax year.
- The total amount of death benefit in force at the end of the tax year.
- Whether the employer has a valid consent from each insured employee (and the number of employees for whom the employer does not have a valid consent).

An employer *is not* required to report policies issued after August 17, 2006 as a result of a 1035 exchange of a policy issued before August 18, 2006. However, a "material increase in the death benefit or other material change to the contract will cause it to be treated as a new contract," and the policy must be reported. However, no guidance is provided on what may be a "material change to the contract."

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Free (of Income Tax) at Last? Using an ESOP to Sell a Business

Martin owns 100% of Fiber Frames, Inc., a C corporation that is in a specialty construction business. He inherited the stock from his father when he was 42. It is currently worth $10 million. On his 62nd birthday, Martin begins to think about retiring and selling the business.

The problem is that Martin can't seem to identify a potential purchaser. He is a widower with two grown children, both of whom will receive a substantial inheritance from Martin. However, his kids are not active in the business and they have no interest in becoming so. Martin has floated the possible sale of the business to several other construction companies, but they aren't interested in buying his business because they are unfamiliar with its specialty.

He has also considered selling the business to one of his employees or a small group, but he can't seem to make a decision. All told, Fiber Frames employs about 30 people. Almost all are long-time, loyal employees, many of whom have been working for him for the entire twenty years he's owned the business. The more Martin thinks about it, the more he's comfortable with the idea of *all* of the employees owning the company.

At a meeting, Martin pitches his idea to the employees. Although they are disappointed to hear that he is thinking of retiring, the idea is met enthusiastically. Following the meeting, Martin hires an expert to conduct an Employee Stock Ownership Plan ("ESOP")[1] feasibility study. The expert analyzes Fiber Frames' financial strength, payroll and tax bracket, among other things, and concludes that an ESOP is suitable for the company.

Martin hires an employee benefits attorney to draft a written ESOP agreement and to help put everything in motion. Once the plan is in place, Fiber Frames will make deductible contributions to the ESOP each year of cash or employer stock or both. If additional employer stock is issued and contributed to the ESOP, Martin's ownership percentage in the company will decline. While this dilutes the value of the stock he owns, it doesn't accomplish Martin's goal of divesting himself of stock.

Instead, Martin needs to sell some or all of his stock directly to the ESOP. It would be nice if this would be a lump sum sale, where Martin receives $10 million cash in exchange for all of his stock. However, the ESOP will have minimal or no cash in its infancy. To buy Martin's stock, the ESOP will have to use a promissory note, borrow money or, more likely, some combination of the two.

Knowing that the ESOP will not be able to borrow $10 million from a bank, Martin initially requests that the ESOP borrow $5 million to use as a down payment, with the remaining $5 million to be paid in installments over five years. The ESOP can borrow the money from Fiber Frames or from a bank. Banks are typically more willing to lend money to a corporation than to

[1] Generally, an ESOP is a qualified retirement plan that must be funded with company stock. As a qualified plan, all of the employees of the company who meet certain eligibility requirements must be allowed to participate. For more on ESOPs and the rules that govern them, see William F. Grady IV, *The Northwestern Mutual Guide to Employee Stock Ownership Plans* (May 2006).

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an ESOP (even with a guarantee from the corporation), and it's unlikely that Fiber Frames itself has $5 million on hand to lend to the ESOP. Therefore, the bank will probably lend the money to Fiber Frames, which in turn, will lend the money to the ESOP. The ESOP can repay Fiber Frames with cash it receives from future deductible employer contributions.

As with any sale, there are tax consequences to Martin on the sale of his stock to the ESOP. Martin's adjusted basis in his Fiber Frames stock is $2 million. In the first year, he will have to pay income tax on $4 million of long-term capital gain ($5 million received less $1 million basis). Each of the five remaining installment payments will result in return of basis of $200,000, long-term capital gain of $800,000, and some amount of taxable interest.

Even though Martin plans to sell the business and retire, he wants to plow the money back into another investment that will provide him with retirement income. Given this, Martin may consider making a § 1042 election. This election will allow him to defer – and potentially avoid altogether – the income tax on the sale of his stock to the ESOP by investing the proceeds of the sale in like-kind property. In order to qualify as a § 1042 election, the stock Martin buys must be C corporation stock and meet certain other requirements.[2]

Generally, here's how it works. Martin uses the sales proceeds to purchase "qualified replacement property," which is limited to stocks and bonds of domestic corporations whose passive investment income does not exceed 25 percent of total income.[3] Many possible investment alternatives, such as annuities, life insurance, mutual funds, government securities, or real estate, are *not* qualified replacement property.[4] Martin, with the help of his tax attorney, identifies stock in several domestic corporations that meets the definition of qualified replacement property and will provide him with income. He must buy this stock within three months before and twelve months after the date of the sale to the ESOP.[5] Martin must make the § 1042 election on his income tax return for the year of the sale.[6]

There is one hurdle with the proposed installment sale – § 1042 requires Martin to purchase the qualified replacement property within twelve months from the date of the sale, but Martin won't have the entire $10 million until five years after the date of the sale.

If Martin can come up with the additional $5 million on his own, this hurdle is cleared. What if he doesn't have access to another $5 million? Fortunately, § 1042 does not require an all or nothing election. For example, if Martin only buys $5 million of qualified replacement property, he will defer tax on half of the gain and pay tax on the other half, spread out over the five years of installment payments.[7]

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[2] See § 1042. This section does not currently apply to owners of S corporation stock although there is stalled legislation that proposes extending the treatment to S corporations. ESOP Promotion and Improvement Act of 2005 (H.R. 3111 and S. 1319). For more on the requirements of § 1042, see William F. Grady IV, *The Northwestern Mutual Guide to Employee Stock Ownership Plans* (May 2006).
[3] § 1042(c)(4)(A).
[4] Proposed legislation would expand the definition of "qualified replacement property" to include mutual funds. ESOP Promotion and Improvement Act of 2005 (H.R. 3111 and S. 1319).
[5] §§ 1042(a)(2) and (c)(3).
[6] Treas. Reg. § 1.1042-1T, Q&A 3.
[7] § 453(c).

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Alternatively, Martin could initially sell enough stock to the ESOP so that it owns a minimum of 30% of the company's total stock.[8] To do this, Martin sells $3 million of stock to the ESOP for cash that the ESOP borrows from Fiber Frames. Within one year from the date of the sale, Martin buys $3 million of qualified replacement property. This satisfies § 1042 for the first year. In subsequent years, Martin can sell as much (or as little) of his remaining stock to the ESOP as it has cash to purchase. Although it may take longer for him to "cash out," doing this allows Martin to defer tax on the sale of all of his stock in Fiber Frames.

If Martin sells any of the qualified replacement property, that gain is "recaptured" and he will have to pay tax.[9] For example, if he sells the initial $3 million of qualified replacement property, he will have recaptured long-term capital gain of $2.4 million ($3 million amount received less basis of $600,000) plus any gain on the stock's appreciation.

If Martin doesn't need all of the income (let alone all of the qualified replacement property), he can begin to make annual exclusion gifts to his children of the qualified replacement property – $12,000 annually per person – and the gift won't trigger any recapture of gain to Martin.[10] If the children sell the qualified replacement property, the recaptured gain is taxed to them, at their rates.[11]

On the other hand, Martin might decide to hold onto all of the qualified replacement property until his death. At his death, there would be no recapture of gain[12] and the qualified replacement property will receive a basis adjustment to date of death value.[13] Except for any post-death appreciation, a sale of the qualified replacement property by Martin's kids is free of income tax.

[8] The ESOP must own at least 30% of (i) each class of outstanding stock or (ii) the total value of all outstanding stock of the corporation after a sale in order for the transaction to qualify for § 1042 treatment. § 1042(b)(2).
[9] § 1042(e)(1). The selling shareholder recognizes gain to the extent of the gain not previously recognized by reason of the purchase of qualified replacement property.
[10] § 1042(e)(3)(C).
[11] § 1042(e)(1).
[12] § 1042(e)(3)(B).
[13] § 1014 and Priv. Ltr. Ruls. 93-39-005 (June 23, 1993) and 1991-09-024 (November 30, 1990).

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Classic Problem, Not-So-Classic Solutions: Using a GRAT to Fund Premiums on a Trust-Owned Life Insurance Policy

First, the familiar problem:

George, age 56, has an estate worth $14 million – including a real estate development company (an S corporation) worth $12 million. George is not married and wants to leave his estate at his death to his two sons. George has already used his $1 million gift tax exemption and does not want to pay gift tax so he is limited to $24,000 each year in annual exclusion gifts to his sons.

In considering his estate plan, and in particular his potential estate tax liability, George and his advisors decide that George should buy $7 million of life insurance. George creates an irrevocable life insurance trust (ILIT) to hold the life insurance, giving his two sons withdrawal rights to qualify up to $24,000 of gifts to the ILIT each year for the annual exclusion. Assume the premium for a traditional whole life policy on George's life is $100,000. George can't cover a gift of $100,000 to the ILIT using annual exclusion; each premium payment will cost him about an extra $35,000 in gift tax – for some, an unappealing prospect.[14]

This leaves George considering either a loan to the ILIT (from himself or a bank) or a non-equity split dollar arrangement to get money to the ILIT to pay the premiums. But both of these require the ILIT to repay something later – either the premiums plus interest for a loan or the entire policy cash value for a non-equity split dollar arrangement.[15] Not an easy task with no remaining gift tax exemption.

Now, some solutions:

1. Short-term Loan or Non-equity Split Dollar Arrangement

We typically think about a loan or non-equity split dollar arrangement as a way to pay life insurance premiums on a trust-owned policy for as long as those premiums must be paid. But what about using the arrangement as a short-term fix?

Doing it this way, George either lends or advances the premium to the ILIT. At the end of 5 years, the ILIT must repay $500,000 in the case of a loan[16] or about $300,000 (the projected cash value in year 5) for a non-equity split dollar arrangement.[17]

When the ILIT buys the life insurance policy, George creates a second trust – a grantor retained annuity trust (a GRAT),[18] with the ILIT as the remainder beneficiary – and funds it with stock in

[14] Note, however, that the premium plus gift tax (about $135,000) is almost the same as George's premium cost if he waits until he's 61 to buy a permanent policy. Keep reading for the significance of this observation.
[15] The split dollar regulations require that George be paid gift tax value, which here we approximate as cash value.
[16] Assumes the interest has been paid annually by the ILIT.
[17] Even though the premium payment is not a gift to the ILIT, the amount of death benefit the ILIT would receive if George died is a benefit conferred on the trust each year. The value of this benefit is measured by an annual term rate derived from either Table 2001 or the insurer's lower rate table. Since the ILIT doesn't have other assets to pay for this benefit, George can use a small part of his annual exclusion to give cash to the ILIT to pay for this benefit.

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his business. Under the following assumptions, George's gift to the GRAT is zero,[19] and the GRAT will pass about $1.5 million[20] of stock to the ILIT when the GRAT ends:

Undiscounted value of property given to GRAT	$6 million
Discounted value of property given to GRAT	$4.2 million[21]
GRAT term	5 years
Annual payment to George	22.6% ($949,200)
Return on GRAT assets	10%

The ILIT can use a portion of the $1.5 million[22] of stock to terminate the non-equity split dollar arrangement or repay the loan and retain the balance. The ILIT can use income from the retained stock to pay future premiums. If the income is sufficient to pay the premiums, George will not need to make any additional gifts to the trust to pay premiums.[23] If the stock doesn't produce enough income to pay the premiums, the ILIT will need to sell some of the stock to fund the shortfall. Since the stock in George's business is not sold on a public market, either George or the business will need to buy the stock from the ILIT.

George now has arranged for a permanent life policy with $7 million of death benefit in an ILIT. In addition, the stock not needed to repay George is outside George's estate, owned by the ILIT. Any growth in that stock is in the ILIT and doesn't increase George's estate. And George has accomplished all this by using 5 years of annual exclusion gifts (for interest on a loan or for one-year term costs for split dollar) and without the need to pay gift tax.

2. Converting Term Insurance

Instead of buying a permanent insurance policy, the ILIT purchases a $7 million term policy insuring George, with an annual premium of $20,000 – an amount George can cover with annual exclusion gifts. But, of course, George's need for death benefit is permanent – he needs permanent insurance.

When the ILIT buys the insurance, George also creates a GRAT with the following assumptions:

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[18] For more information on GRATs, see the Advanced Planning Trifold titled "Grantor Retained Annuity Trusts."

[19] Assumes a § 7520 rate of 4.2% (February 2008).

[20] This value takes into account the 30% discount applied to the stock when it was contributed to the GRAT. The same factors (minority interest and lack of marketability) that made a discount appropriate to apply to determine the fair market value of the stock when it was contributed to the GRAT still apply when the GRAT terminates and the stock passes to the ILIT.

[21] Assumes a 30% discount for minority interest and lack of marketability.

[22] What if George didn't have assets growing at 10% for which a 30% discount is appropriate to fund the GRAT? If the assumptions remain the same, but the assets return 6%, the GRAT passes about $500,000 to the ILIT. If the assumptions remain the same (that is, 10% growth), but it is not appropriate to apply any discount to the stock, the GRAT passes about $1.3 million to the ILIT.

[23] Even if the stock doesn't generate the assumed return for a given year, George will not need to make gifts until and unless the ILIT has sold all of the stock (probably to George or the business) to pay premiums.

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Undiscounted value of property given to GRAT	$5 million
Discounted value of property given to GRAT	$3.5 million[24]
GRAT term	5 years
Annual payment to George	22.6% ($791,000)
Return on GRAT assets	10%

George names the ILIT as the remainder beneficiary of the GRAT. George's gift upon creation of the GRAT is zero.[25] At the end of a 5 year term, the GRAT's assets (projected to be about $1.3 million)[26] pass to the ILIT. The ILIT can use some of these assets to convert the policy to a permanent policy. It will have been important for George to have chosen a term product with a conversion period that works with the term of his GRAT.

The premium, however, now that George is 61, is no longer $100,000; it is $135,000 each year. Income (and principal, if needed) from the stock can be used to pay the premiums each year. As was the case above, George's ILIT now has permanent insurance with a death benefit of $7 million, plus some stock, all outside of George's estate.

3. Use an Existing GRAT

This is one of those nearly too-good-to-be-true solutions. If George had created a GRAT in the past and if the remainder beneficiaries of that trust would be appropriate owners of the life insurance policy (for example, his kids), the beneficiaries could use the assets they received from the GRAT (or income from those assets) to pay the premiums on George's life insurance policy.

[24] Assumes a 30% discount for minority interest and lack of marketability.
[25] Assumes a § 7520 rate of 4.2% (February 2008).
[26] This value takes into account the 30% discount.

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A Knight's Round Table – No Clear End to the Question: *Knight v. Comissioner*, 552 U.S. ___ (2008)

Background: Trust expenses are deductible on the trust's income tax returns. That has never been the issue; what has caused rumblings and consternation in the past few years has been the deductible amount. Under § 67(e)(1), "the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate" are fully deductible and not subject to the 2% floor. Ah, that is the issue – what trust expenses (if any) are deductible only to the extent they exceed 2% of adjusted gross income. Trusts with significant income can lose the benefit of a major portion – perhaps all – of any expenses that are subject to the 2% floor.

Courts of Appeals have decided differently, and those that have identical results have different reasons for getting there. Investment fees were at the center of those controversies.[27] Due to these conflicts, the U.S. Supreme Court decided to hear the *Knight* case.

Issue: Whether a trust's investment fees are subject to the 2% floor on the trust's income tax returns?

Holding: In a unanimous decision, the trust's investment fees are subject to the 2% floor.

Rationale: The Court wanders down the path of statutory construction (would v. could, etc.), which we won't bore you with. From the meanderings of that path, the Court sets forth this rule: pretend the property is held by an individual; then, only those costs that are uncommon or unusual or unlikely for an individual to incur are not subject to the 2% floor. We hate rules with 2, 3 and even 4 negatives. In the interest of making this understandable, we are so bold as to suggest that the rule is: expenses commonly, usually and likely incurred by an individual are subject to the 2% floor when incurred by a trust. Since investment fees are not uncommon expenses for individuals, these fees are subject to the 2% floor on the trust's income tax returns.

Observations:

- The Court admits that its rule "entails some uncertainty." How are trustees supposed to figure out what is "common"? Because of increased preparer penalties, income tax preparers will likely err on the side of being very conservative, with the result that most expenses will be reported as subject to the 2% floor – a virtual government victory.
- The decision hints that special charges by investment counsel applicable only to fiduciary accounts may be fully deductible. Will we now be seeing a different structure to investment fees? Probably.
- The holding is limited to investment fees but the rationale enunciated by the Supremes could apply to other trust expenses.

[27] For a discussion of the earlier cases and the reasoning of the different Courts of Appeal, see Clear as Mud – Deductibility of Trust's Investment Fees: *William L. Rudkin Testamentary Trust v. Commissioner*, 98 A.F.T.R.2d (2nd Cir. 2006), *Advanced Planning Bulletin* (December 2006). The *Rudkin* case is the *Knight* case in this Supreme Court decision.

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- The I.R.S.'s proposed regulations limiting full deductibility to "unique" expenses are now out the door and as an I.R.S. representative put it "I don't know where we're going."[28]

Unfortunately, legislative action appears to be the only way to draw a bright line. Perhaps that is where efforts should now be placed.

[28] Tax Notes Today, January 23, 2008.

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Tax Court Denies Deductions For A § 419A(f)(6) Multiple Employer Plan . . . And It's A Bad Omen for Many § 419(e) Plans Too: *DeAngelis v. Commissioner*, T.C. Memo 2007-360

Background: Readers of this Bulletin are familiar with the several hurdles employers face when seeking deductions for contributions to "welfare benefit plans" (also called "419 Plans"):

1. The contributions must be an ordinary and necessary business expense (see § 162);

2. The plan has to truly provide welfare benefits – e.g., severance, death, medical – rather than provide disguised dividend or compensation payments (current or deferred); and

3. Contributions have to either –

   i. fit within the deduction limits imposed by §§ 419/419A (arrangements claiming to do this are often called "419(e) single employer plans"), or

   ii. escape these deduction limits through an exception, such as that for "multiple employer plans" under § 419A(f)(6).

In the past few decades, 419A(f)(6) multiple employer plans were the most heavily-promoted type of plan, but since 2003 when the Treasury Regulations stomped out most of them,[29] many marketers have shifted to 419(e) plans that claim to fit within the 419/419A deduction limits, while still supposedly providing big deductions with little income. But just a few months ago, most 419(e) single employer plans got hammered by the I.R.S. too.[30] Nonetheless, plenty still sell 419(e) plans and a few outfits still hawk 419A(f)(6) plans as aggressively as ever.

In *DeAngelis v. Comm'r*, the Tax Court analyzed an employer's claimed 1993 and 1994 deductions under an old 419A(f)(6) arrangement. Even though these types of plans are not sold frequently anymore, the court's opinion offers ominous lessons not only for the few multiple employer plans still around, but also for the many 419(e) single employer plans that are promoted nowadays.

Facts: Five physicians operate their practice as a partnership, which employs about 30 non-physicians (nurses, etc.). The partners are S corporations for which each physician is the sole owner and sole employee. Four of the S corporations adopt a 419A(f)(6) plan called the STEP Plan – Severance Trust Executive Program Multiple Employer Supplement Benefit Plan – where the S corporations make supposedly deductible contributions to the partnership, which in turn

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[29] See Are You Experienced? Hendrix Lives – But Your 419 Plan Is Dead: Treasury Decision 9046 (July 17, 2003), *Advanced Planning Briefs* No. 56, (August 2003).

[30] See We Hate [i.e., Love] To Say We Told You So, But . . . 419(e) Plans Limited To "Qualified Direct Cost" Don't Work Whatsoever, And Those Providing "Post-Retirement Medical Benefits" Are In The Crosshairs Too: Revenue Ruling 2007-65, 2007-45 I.R.B. 949; Notice 2007-83, 2007-45 I.R.B. 960; and Notice 2007-84, 2007-45 I.R.B. 963 (October 17, 2007), *Advanced Planning Bulletin*, November 2007.

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makes supposedly deductible contributions to the STEP Plan. The plan then buys permanent cash value life insurance policies on the doctors (and their spouses) to ostensibly provide severance benefits to the doctors.[31] The insureds name the beneficiaries for the policies' death proceeds – generally their irrevocable trusts – and eventually, the policies are transferred to the insureds.

In line with § 419A(f)(6) requirements, the STEP Plan's marketing materials purport to pool employer contributions of multiple employers into a common fund, but the court finds that the plan operated merely as a collection of separate accounts (i.e., benefits to employees are purely a function of the cash value insuring that employee – effectively meaning it's impermissibly experienced-rated).[32] The marketing materials and the plan administrator instructed participants how to time their departures from the business and how to phrase their requests for benefits so that the trustee could characterize distributions as being due to a "severance." Even so, the court finds that, in operation, the plan made distributions to participants without them satisfying written requirements for severance benefits, and such distributions were not dependent upon any unexpected or contingent event (implying that this is a requirement for any severance, so "firing yourself" wouldn't do).[33]

Promotional materials contain a "more likely than not" legal opinion letter saying the deductions will be allowed, written by the attorney who drafted the STEP Plan and served as its counsel from inception.

Issue: Are the S corporations' and partnership's payments to the STEP Plan deductible as contributions to a welfare benefit plan providing severance benefits and exempt from §§ 419/419A deduction limits due to the § 419A(f)(6) exception?

Ruling: No, the contributions to the STEP Plan are not deductible contributions to a severance plan. Instead, the court rules that the convoluted two-step transaction of the S corporations' payments to the partnership, followed by the partnership's contributions to the STEP Plan, are simply a non-deductible S corporation distribution to each doctor-shareholder. This has the effect of increasing each doctor's current income from his solely-owned S corporation.

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[31] Perhaps indicative of the sloppiness of the arrangement, the doctors claim that the partnership's contributions to the STEP plan qualify as a severance plan for *partnership employees*, even though only one participant is an employee of the partnership (an office manager) and all other benefited parties are the doctors who are actually employees of the *S corporations*. Also, the S corporations' payments to the partnership are simply labeled "forwarding fees."

[32] One requirement of the § 419A(f)(6) exception is that the plan *not* be experienced-rated. See § 419A(f)(6)(A). The plan stated that a plan actuary would calculate the necessary contributions to provide severance benefits, but it never hired an actuary.

[33] Section 419 guidance on how to distinguish "severance" pay from deferred compensation has long been murky or non-existent. Common-sense and ERISA regulations imply that any severance must be due to an the *involuntary* termination of employment – see, e.g., 29 C.F.R. § 2510.2-2(b)(1) – but other definitions of severance haven't explicitly required this – see, e.g., Treas. Reg. § 415(a)-1(f)(5) (concerned with whether a new employer continues the qualified plan). Promoters have frequently exploited this imprecision by tacitly encouraging owner-employees to terminate their own employment, but the 2003 final § 419A(f)(6) regulations should curtail this. They state that impermissible experience-rating is evidenced by any "non-standard benefit trigger," and included in this category are plan distributions for reasons other than "illness, personal injury, or death of an employee or family member, or the employee's *involuntary* separation from employment." Treas. Reg. § 1.419A(f)(6)-1(c)(6) (emphasis added).

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Reasoning: The court wasn't fooled for a minute. It looked at why the doctors got into the plan – some of their attorneys suggested it was a good estate planning or wealth accumulation technique – and how the plan was actually marketed and operated instead of just looking to the plan's carefully crafted documents. Typical of the court's comments is this passage:

> The intent of the STEP plan was to create an incentive to buy, and thus to generate the sale of, whole life insurance policies through a claim of permissible tax avoidance and the ability to pay and deduct premiums on the purchased policies which would eventually be transferred to and owned by the insureds. Many participants in the STEP plan believed that the plan was one of deferred compensation.

Despite the doctors' apparent belief that they were in a *deferred* compensation plan, the fact that the insureds were able to control the policies as if they owned them directly – and that the promoter, plan administrator, and insurance company all viewed it the same way – led the court to treat it as essentially a *current* compensation plan. Of course, since plan participation was mainly based on S corporation ownership status and not employee status, it was essentially an S corporation distribution rather than a bonus. But due to S corporation tax rules, either way the doctor is personally taxed currently on the premium amount.

Analysis: The court's reasoning is sound and gives important lessons regarding any welfare benefit plan – old or new – and whether intending to fall under the § 419 limits or escape them.

1. *Yes, even your 419(e) single employer plan has these problems.* The taxpayers' arguments made it clear that they pinned virtually all their hope on satisfying the multiple employer exception and meeting its requirements of establishing a common fund for pooled employer contributions, rather than merely being a collection of separate experienced-rated plans. But the court rejected the STEP Plan before the analysis got that far because the plan never cleared the first hurdles of establishing a true welfare benefit plan and generating ordinary and necessary business expenses. This should be sobering to those business owners targeted by modern day 419(e) plan promotions, which – just like the rejected 419A(f)(6) plan here – have to first run the gauntlet of providing deductible expenses that also constitute a legitimate welfare benefit *before* § 419 even becomes relevant. If the 419(e) promoter you're dealing with tries to dismiss this case as irrelevant because it deals with a 419A(f)(6) plan, be suspicious.

2. *The plan's actual operation and marketing materials are important too.* The I.R.S. has feasted off these courses for years. If you enter into a welfare benefit plan and think you're safe just because the plan document dots all "I"s and crosses all "T"s (which it probably will), think again. The I.R.S. isn't blind. And courts have subpoena power. When judges have to decipher whether your business' payments really qualify as deductible contributions to a welfare benefit plan, be prepared for an examination that looks into all conversations and correspondence both before and after the plan was adopted, *and* how the plan was actually operated once in place. If it doesn't look, walk, and quack like a legitimate 419 plan, it won't be taxed as one. The problem, of course, is that too many small business owners are told verbally that they're getting a deductible

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deferred compensation arrangement that gives estate tax free death benefit, but they miss the fact that the mountain of inscrutable paperwork they sign at the plan's inception denies that these features are offered. This probably won't protect the guy paying taxes, but it might protect the promoter from a later lawsuit when the plan blows up. What enduring solace that the victim can save the promotor's bacon.

3. *Experts and legal opinions*. The court dismissed the testimony of the STEP Plan's witnesses (including the attorney who drafted the plan and their actuarial expert witness). The court basically didn't believe them because they all were in bed with and paid by the promoter from day one. No matter how sophisticated the promoter's advisors are and how pretty their materials look, don't rely on just them. Hire your own sophisticated legal counsel.

4. *Buying junk just to get a deduction?* A side controversy in this case is that some policies didn't perform as well as the participants hoped – one doctor griped that his death benefit decreased by $3.5 million. This should remind everyone to not let the tail wag the dog. In addition to scrutinizing the overall welfare benefit plan, look hard at any underlying policy being purchased. If it's really a piece of junk, no deduction makes it worthwhile.

5. *Judge Laro – friend or foe?* Those who have read the legal opinions that accompany many welfare benefit plan marketing materials – any variety – are familiar with the near love affair that promoters have with Judge Laro's opinion in the *Booth* case.[34] That case denied deductions for a § 419A(f)(6) plan, but marketers persistently hype Laro's statement that "severance plans have an element of deferred compensation." So promoters often praise Judge Laro as eloquent, lucid, or more. But Laro wrote the *DeAngelis* opinion; we wonder if promoters will still be so fond of him.

6. *The I.R.S. can catch you well after the promoter's gone*. In a previous article, we warned that the I.R.S. can catch up with a business owner well after the contributions have been made and the promoter has collected his commission.[35] This *DeAngelis* case is a great example; it's based on tax years 1993 and 1994. If you don't want a cloud hanging over you years later (isn't retirement supposed to be relaxing?), tread carefully early on.

7. *Today's 419(e) promoter was yesterday's 419A(f)(6) promoter.* Firms marketing 419(e) single employer plans today put a lot of effort into distinguishing their plans from the "bad" 419A(f)(6) multiple employer plans that have gotten their teeth kicked in over the past few years. Naturally, these 419(e) promoters are very confident that their plan works. But ask the promoter:

    - Did you used to – or do you still – confidently market 419A(f)(6) arrangements?
    - Are the main players – you, the trustee, administrator, insurance company, etc. – the same?

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[34] *Booth v. Commissioner*, 108 T.C. No. 25 (1997).

[35] See Another Update on Tax Shelters, Penalties, and Defenses: Notice 2007-54. 2007-27 I.R.B. 12 (May 25, 2007); Treasury Decisions 9350, 9351 and 9352 (August 3, 2007), Advanced Planning Bulletin, September 2007, particularly the last paragraph entitled, "It's partly the government's fault . . . but it's the little guy who pays."

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- And did you used to market 419(e) plans based on Qualified Direct Cost – which just became listed transactions – before pushing only 419(e) plans based on Post-Retirement Medical Benefits?[36]

This current case offers an example of where the answers to these questions might be enlightening – do some digging before you write the check.

[36] See Revenue Ruling 2007-65, 2007-45 I.R.B. 949 (October 17, 2007); Notice 2007-83, 2007-45 I.R.B. 960 (October 17, 2007); and Notice 2007-84, 2007-45 I.R.B. 963 (October 17, 2007). Arrangements that are listed transactions carry the most burdensome kind of disclosure and penalty rules.

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More on Tax Shelters – Patented Tax Strategies, Circular 230 Regulations, and Tax Preparer Penalties: REG 129916-07 (September 26, 2007); Treasury Decision 9359 (September 25, 2007); and Notice 2008-13, 2008-3 I.R.B. 1 (December 31, 2007)

Background: The federal government's never-ending drip of tax shelter rules continues. This time the affected areas are Circular 230, tax preparer penalties, and patented tax strategies. We cover the updates to these topics here, but see some of our past articles to get a more comprehensive view of tax shelter rules.[37]

Circular 230: The pun's too easy, but fits too well. Why are the regulations governing tax practice before the I.R.S. called a "Circular?" Because of the annoyingly "circular" manner in which they're written! (Pause for laughter.) The statute authorizing these regulations is 31 U.S.C. § 330, and it applies to "representatives" of taxpayers before the Department of Treasury. The regulations have long equated this with those who "practice before the I.R.S.," and their provisions have always affected only to these people – and still do. But there also has been uncertainty about whether "practitioners" encompass *any* licensed attorney, or only those who affirmatively claim to represent a taxpayer before the I.R.S. (e.g., by signing a tax return).[38] For many years the issue wasn't that important, but became more so recently, particularly since the American Jobs Creation Act of 2004 amended the underlying statute to authorize *monetary* penalties for violations of the Circular.[39]

The particularly worrisome portions of the Circular are § 10.35 and § 10.37, both of which contain rules governing *written advice by a practitioner*. The application of these provisions is potentially very broad: "written" covers even email; and "advice" is undefined so it could encompass nearly any statement, even if solely intended as educational. So the best way out seems to not be a "practitioner" to begin with. Treasury knew of the need for more clarity about who counts as a practitioner before finalizing the regulations,[40] but they left us with this looping logic anyway:

- § 10.2(a)(5) defines "practitioner" as any individual described in § 10.3(a), and

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[37] For a primer on tax shelter rules generally, see Another Update on Tax Shelters, Penalties, and Defenses: Notice 2007-54, 2007-27 I.R.B. 12 (May 25, 2007); Treasury Decisions 9350, 9351 and 9352 (August 3, 2007), *Advanced Planning Bulletin,* September 2007. For analysis on Circular 230 in particular, see 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; and Brief Summaries in *Advanced Planning Bulletins* of March 2006 (discussing REG-122380-02) and June 2007 (discussing Notice 2007-39 regarding monetary penalties). For a description of a recent patented tax strategy case, *In re Comiskey*, 499 F.3d 1365 (Fed. Cir. 2007), see Brief Summaries in *Advanced Planning Bulletin*, November 2007.

[38] This article refers to only attorneys, but potential "practitioners" also includes CPAs, enrolled actuaries and some others. See 31 C.F.R. § 10.3. For reading ease, sections of Circular 230 are hereafter cited as simply "§ 10.xx" rather than "31 C.F.R. § 10.xx."

[39] Before monetary sanctions, the strongest penalty was basically disbarment from practice before the I.R.S., but an attorney who already didn't consider himself to engage in such practice probably wouldn't be bothered. The monetary sanction can be as large as the attorney's fees from the transaction. § 10.50(c).

[40] See Treasury Decision 9359 (September 25, 2007). The final regulations apply on September 26, 2007.

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- § 10.3(a) is entitled, "attorneys," but it doesn't simply define a practitioner in terms of status (e.g., any licensed attorney); instead it says that any licensed attorney who renders written advice covered under § 10.35 or § 10.37 is considered to be practicing before the I.R.S., but again,
- § 10.35 or § 10.37 covers written advice only *if* it is authored by a practitioner in the first place.

Huh? That "who's on first" makes Abbott and Costello look like amateurs. But it's also a final regulation, so you have to take it seriously. Play it safe. If you put anything in writing that's tax related and you don't intend it to be something folks can rely on – and something as innocuous as "IRAs grow tax deferred" theoretically could be covered – then you probably should use the disclaimer that gets you out of the "covered opinion" requirements of § 10.35 (see end of this document for an example).[41] Getting out of § 10.37's "other written advice" requirements isn't so easy. This section has no disclaimer escape hatch, and among other things it commands that a practitioner must not give written advice if it's based on unreasonable factual or legal assumptions, or if the practitioner hasn't consider all the relevant facts he knows or should know. Luckily, practitioners are generally not subject to sanctions – monetary or disbarment – unless they violate § 10.35 or § 10.37 "recklessly or through gross incompetence," or if they're "incompetent or disreputable."[42] But it might be a good idea to use your cell phone more often anyway.

On another front, Treasury issued proposed regulations under § 10.34 relating to standards for practitioners who sign or advise on tax returns.[43] These changes are meant to harmonize these Circular 230 rules with new guidance in this area that has come from other quarters (see below).

Penalties on tax return preparers: On New Year's Eve, Treasury issued Notice 2008-13 to provide interim guidance (regulations are promised later in 2008) regarding the stiffened penalties on preparers of tax returns that were created by 2007 amendments to § 6694.[44] The penalty now extends to preparers of any tax returns, not just income tax returns, and it is at least $1,000 and can be as high as 50% of the return preparer's fee. Pursuant to the statute, any amount of tax underpayment can lead to a penalty if the preparer knew (or should've known) of the position giving rise to the tax liability. But this penalty can be avoided if the taxpayer's position is:

[41] Another reason to interpret the Circular broadly is that § 10.2(a)(4) states that "practice before the Internal Revenue Service" comprehends all matters connected with a presentation to the I.R.S., and such presentations include "rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion." Unfortunately, this doesn't address the definition of "practitioner" as directly as the other cited sections.

[42] See §§ 10.50 (Sanctions), 10.51 (Incompetence and disreputable conduct), and 10.52 (Violations subject to sanction).

[43] REG-138637-07 (September 19, 2007), effective January 1, 2008.

[44] Notice 2008-13, 2008-3 I.R.B. 1 (December 31, 2007). Treasury simultaneously issued two companion Notices: Notice 2008-11, 2008-3 I.R.B. 1 (addressing the transitional relief provided in Notice 2007-54 concerning due dates for filing returns and generally stating that the new rules apply starting in 2008); and Notice 2008-12, 2008-3 I.R.B. 1 (relating to penalties under revised § 6695(b) regarding signature requirements for tax return preparers). The statutory amendments came in the Small Business and Work Opportunity Tax Act of 2007, P.L. 110-28 (121 Stat. 90). The penalty also can apply to preparers of claims for refunds.

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- disclosed on the return, and the preparer has a reasonable basis for it, or
- not disclosed on the return, and the preparer has a reasonable belief that it's more-likely-than-not (> 50%) the correct position.

Even without meeting these standards, the penalty does not apply if the preparer acted in good faith and there's reasonable cause for the understatement. That's a lot of use of the word "reasonable"– basis, belief, and cause – for one statute, so sorting out its standards is tough.

The I.R.S. recognizes these difficulties,[45] but Notice 2008-13 is meant to offer some direction, giving twelve examples of fact situations where the statute is or is not violated, and three long lists of tax forms that (i) count as returns covered by the statute, (ii) count only if the information in the form constitutes a "substantial portion" of the return, or (iii) won't count unless filled out willfully or recklessly to understate liability. For example, if you fill out an individual's 1040, you're a tax preparer. If you prepare a Form 1065 partnership tax return, you're a preparer of the individual partner's return only if the partnership income is a substantial portion of his income. If you just create the W-2s for the business, you're not a preparer unless you willfully understate what's taxable or recklessly disregard the rules.

These rules contain plenty of intricate difficulties, including the potential tension between the taxpayer and the practitioner preparing the return. If the facts underlying a tax position are not disclosed on the return – probably the norm – the *taxpayer* generally can avoid penalties as long as he has substantial authority for the position.[46] But if that same position results in an underpayment, the *return preparer* could be subject to penalties unless he meets the higher standard of having a reasonable belief that it's more-likely-than-not the right position. Rational self-interest being what it is, many taxpayers might forego the attention-getting act of disclosing a position on their return when the only upside is that it helps a paid tax preparer avoid penalties.

And a practitioner has less control over what's filed with the I.R.S. than most people would think. In fact, you can be deemed to be a return preparer even if you never sign – or even see – the ultimate tax return. Preparing mere depreciation schedules can be enough to rope you in. Even worse, just giving *oral* advice that a person uses for his return can make you a preparer. Luckily, you can normally extract yourself from penalties if you advise the taxpayer to disclose the position, and showing good faith doesn't necessarily require checking the accuracy of information given by others – e.g., accountants, appraisers – unless it looks incorrect on its face. Still, it's scary enough that you might want to watch what you say on that cell phone too.

Patented Tax Strategies: This is actually kind of interesting. A few months ago Treasury issued proposed regulations that added patented tax strategies to the realm of reportable transactions, meaning taxpayers will have to send special forms to the I.R.S. telling about their participation in any such arrangements, and material advisors (e.g., promoters) will have to keep

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[45] On January 30, 2008, Thomas Kane, special counsel to I.R.S. Office of Chief Counsel, reportedly commented that the statute's language is overly ambiguous and makes any bright-line test difficult to create. See Tax Notes Today, 2008 TNT 21-4.

[46] See §§ 6662(d)(2)(B)(i). Having substantial authority means that the weight of tax authorities supporting the position is substantial in relation to contrary authorities. Treas. Reg. § 1.6662-4(d)(2).

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a list of these participating taxpayers.[47] This will make it easier for the I.R.S. to find – and audit – anyone using a patented plan, which should mean fewer taxpayers will buy into them.

The need for such regulations might surprise many folks. When normal people think of things that merit a patent, they think of light bulbs, computer hardware, or artificial hearts. You know, useful stuff. But obtaining a patent on a *tax strategy*? On a mere idea of how to arrange your affairs so you can report (or not report) your taxes in a more favorable manner? Is that even patentable? Well, there's some ambiguity on the matter, but basically, yes.

The right to receive a patent derives from the U.S. Constitution, where it states that Congress has the authority to "promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries."[48] This Congressional authority is expressed in Title 35 of the U.S. Code, which states that an invention is patentable if it meets these requirements:

- Subject matter – four types of things are patentable: a process, machine, manufacture, or composition of matter.[49] The term "process" means a process, art, or method.[50]
- Novel – it must be new, so it must not have been disclosed by earlier patent, publication, or otherwise generally known or used by others.[51]
- Useful – it must be operable and provide a tangible benefit.[52]
- Non-obvious – it must not be obvious to someone of ordinary skill in the art to which the thing pertains.[53]

The notion that tax strategies are patentable is a subset of the idea that "business strategies" are patentable, itself a controversial enough idea until the *State Street Bank* case of 1998.[54] The case concerned a data-processing system that accounted for and provided values for separate mutual funds that together formed a partnership. The trial court first rejected the patent since any accountant can do the same thing (albeit slower) with pen and paper, but the Court of Appeals approved the patent and specifically rejected the notion that business methods are *per se* non-patentable (although the court did say the patent at issue claimed more than a mere abstract idea). Shortly thereafter, patent laws were amended to provide a limited defense against infringement for first users of a method who didn't happen to win the race to the patent office. This First

[47] REG-12991607 (September 26, 2007).
[48] U.S. Const. art. I, § 8, cl. 8.
[49] 35 U.S.C. § 101.
[50] 35 U.S.C. § 100(b).
[51] 35 U.S.C. § 102.
[52] 35 U.S.C. § 101, and see *In re Fischer*, 421 F.2d 1371 (Fed. Cir. 2005).
[53] 35 U.S.C. § 103(a).
[54] *State Street Bank and Trust Co. v. Signature Financial Group*, 149 F.3d 1368 (Fed. Cir. 1998). Ninety years earlier, when considering a method of cash-registering and account-checking to prevent fraud by cashiers and waiters, another court stated that a system of transacting business is not an art that is patentable. But it also criticized the method as obvious, so it's not clear if that was the ground for refusing the patent, or if the court was holding that business methods are unpatentable subject matter altogether. *Hotel Security Checking Co. v. Lorraine Co.*, 106 F. 467 (2d Cir. 1908).

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Inventor Defense Act specifically refers to infringements relating to methods in a patent, and states that "the term 'method' means a method of doing or conducting business."[55]

In any event, the Patent and Trademark Office has decided that tax strategies are patentable business methods. But surely the Office grants patents only for the most sophisticated tax arrangements, such that lawyers who regularly crank out planning techniques for their clients don't have to worry about stumbling into infringements. Maybe not. A review of the tax strategies that have already received patents reveals ideas that appear rather mundane, such as "a method and apparatus for tax efficient investment management," and "a computerized system and method for optimizing after-tax proceeds," and many others.[56]

But having a patent doesn't end the story. The issuance of the patent gives the patent holder the power to sue alleged infringers and patents are presumed valid, but defendants can rebut this presumption by showing that the invention shouldn't have been patentable in the first instance.[57] In the world of tax strategies, a common defense probably will be that the patented plan is either not novel or would be obvious to other tax practitioners.

Recent litigation in the federal District of Connecticut almost gave us a chance to see how this would play out. In *Wealth Transfer Group v. Rowe*, the plaintiff claimed infringement of its "SOGRAT" patent.[58] The defendant, a former executive at AETNA, apparently used in his personal planning the patented technique, which according to its abstract is an estate planning method designed to lessen transfer taxes by putting stock options in a GRAT so they appreciate outside the grantor's estate.[59]

Not to be unkind, but that sounds pretty lame for something that's patented. Unfortunately (for us, at least), the parties reached a confidential settlement in March of 2007, so the court never commented of the merits of this patented technique or tax strategies generally.

To confuse matters further, in September of last year, the Federal Circuit Court of Appeals affirmed the denial of a patent application relating to a business method for mandatory arbitration involving legal documents such as wills or contracts.[60] Before even reaching the issues of novelty or obviousness, the court rejected the method as unpatentable subject matter, explaining that business systems "that depend entirely on the use of mental processes" are not patentable, and that "the application of human intelligence to the solution of practical problems is not in and of itself patentable." This would seem to quash virtually any tax strategy patent, but in trying to reconcile these statements with its previous decision in *State Street Bank* and other

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[55] 35 U.S.C. § 273(a)(3). Enacted as part of the American Inventors Protection Act, P.L. 106-113, 113 Stat. 1536 (1999).

[56] U.S. Patent No. 7,031,937; and U.S. Patent No. 6,115,697. According to a recent Congressional Research Service Report, the U.S. Patent and Trademark Office organizes business method patents within class 705, and tax strategies fall into a subclass having classification number 705/36T. As of January 10, 2008, there were 60 patents and 106 applications in this subclass. See *Patents on Tax Strategies: Issues in Intellectual Property and Innovation*, by John R. Thomas, Congressional Research Service, RL34221, 2008 TNT 21-23 (January 10, 2008).

[57] 35 U.S.C. §§ 281-284.

[58] *Wealth Transfer Group, LLC v. Rowe,* D. Conn., Case No. 3:06-cv-00024-AWT.

[59] U.S. Patent No. 6,567,790.

[60] *Comiskey*, 499 F.3d 1365 (Fed. Cir. 2007).

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cases, the court also stated that "when an unpatentable mental process is combined with a machine, the combination may produce patentable subject matter." Where the line is drawn – and what it means for tax strategy patents – is anyone's guess.

Ah, but there's more. Congress has gotten into the act. Currently there are several bills making their way through the legislature that either would deny patentability for tax strategies or curtail available damages for their infringement.[61] If and when something passes, we'll let you know.

For now, there are the proposed reportable transaction regulations. According to the preamble, part of the reason Treasury issued these is to counteract the mistaken view that the granting of a patent by the Patent and Trademark Office necessarily means that the I.R.S. also approves of the plan's claimed tax benefits. That's an important message to get across, as many people might get that wrong impression and promoters will be quick to exploit it.

As for the details, parties required to report participation include not only the buyer of the strategy, but the selling patent holder too, along with related parties of either.[62] If you just use the strategy – e.g., you're an infringer – then you don't have to report.[63] For promoters, it's easy to be labeled a material adviser because the minimum fee is lower: a mere $250 if the benefited taxpayers are natural persons (down from the normal $50,000), and $500 for others (down from $250,000).[64] If made final, these rules will apply as of September 26, 2007.

Conclusion: Practicing as a tax attorney is hard enough in the best of times. Now it's getting ridiculous. When making virtually any communication, even the most honorable of attorneys has to worry about whether the statement violates Circular 230, constitutes preparation of a return, or violates somebody's patent. It hardly makes all the fame and fortune worth it.

[61] Proposed during 2007 have been H.R. 1908, H.R. 2136, H.R. 2365, S. 681, and S. 2369.
[62] Prop. Reg. § 1.6011-4(b)(7).
[63] Prop. Reg. § 1.6011-4(c)(3)(ii), Example 7.
[64] Prop. Reg. § 301.6111-3(b)(3)(i).

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Life Insurance Cash Value and Creditor Protection: Less Than Meets the Eye?
Dowling v. Chicago Options Associates, Inc., No. 96 CH 4430, 2nd Div. (Mar. 28, 2006)[65]

We've long cautioned that creditor protection for the cash value of life insurance is not a clear cut issue. Some states provide broad protection while others provide virtually none. For a client concerned about creditor protection, this Illinois court case again demonstrates the need to obtain counsel.

Facts: Creditor wins a judgment against a corporation and Davis. Creditor seeks to collect the judgment under Illinois law by demanding that Davis turn over assets, including a life insurance policy owned by and insuring Davis. The policy beneficiary is an irrevocable life insurance trust (ILIT).[66] Davis' children are the ILIT beneficiaries.

Davis objects to the order requiring him to turn over the policy, citing Illinois law which exempts life insurance from creditors' claims. The statute protects:

> All proceeds payable because of the death of the insured and the aggregate net cash value of any or all life insurance and endowment policies and annuity contracts payable to a wife or husband of the insured, or to a child, parent, or other person dependent upon the insured, whether the power to change the beneficiary is reserved to the insured or not and whether the insured or the insured's estate is a contingent beneficiary or not;[67]

Issue: Is Creditor entitled to the cash value of the policy?

Holding: Amazingly enough, the court holds that Creditor is entitled to the cash value since Davis' children are not the named beneficiaries of the policy – the ILIT is the direct beneficiary. The court declines to "look through" the trust to the trust beneficiaries.

Observations: The court's interpretation of the statute is unreasonably restrictive and irresponsibly disregards the intent of the legislature. The goal of the statute is to ensure that life insurance proceeds are available for the debtor's family. In naming the ILIT as the policy beneficiary and his children as the ILIT beneficiaries, Davis clearly intended to have the contract benefit his children. The court's refusal to look through to the trust beneficiaries is puzzling, considering the intent of the statute.

Estate planners have long counseled clients to name a trust for children – as opposed to naming children directly as the beneficiary of life insurance. Estate planners in Illinois (and perhaps

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[65] The case wound its way up and down the Illinois court system as various issues were litigated. The creditor protection of life insurance was not an issue in those other decisions.

[66] The facts do not explain why Davis owned the policy and named an irrevocable trust the beneficiary. There is no estate tax advantage to this arrangement. § 2042.

[67] 735 ILCS 5/12-1001(f).

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other states with similarly worded statutes) need to revisit their advice to clients in light of this decision.

The case demonstrates the poor drafting of many creditor protection statutes. Planners often hear that life insurance is protected from creditors in a given state, but that protection often is limited in a way similar to the Illinois statute.

Does using a Northwestern Mutual Trust for Minor Beneficiary form (F.O. 90-1197-01)[68] expose the policy to creditors in Illinois? Probably; with this form, a trust – exactly the problem for Davis – will receive the death benefit.

Suggestions:

1. A client concerned with creditor protection of life insurance needs to obtain his own counsel who can thoroughly research the relevant statutes and case law.
2. Follow the language of the statute. Had Davis followed the literal language of the statute by naming his children as the direct beneficiaries of the policy, the creditor could not have reached the cash value.
3. Use an irrevocable trust. A properly drafted irrevocable life insurance trust as the *policy owner* will provide protection from the creditors of the insured.[69] Likewise, using Northwestern Mutual Trust for Minor Owner can provide similar protection.[70]

[68] This form provides for death proceeds to be held in trust if a named beneficiary is under age 21.
[69] See section V of Unconventional Uses of Trusts, *Advanced Planning Bulletin*, August 2006 for more information.
[70] When someone under age 21 is to be owner of a policy, this procedure names a trust for that person as owner.

Wash Sale

Revenue Ruling 2008-5, 2008-3 I.R.B. 271 (December 21, 2007)

If taxpayer's stock goes down in value, he can sell it and report a capital loss. This loss can offset gains on other sales, and even result in a deduction of up to $3,000. What prevents many people from selling is that they want to hold the stock until it goes back up. So why not sell it one day and buy it back the next? You could get the best of both worlds – report the tax loss and get the appreciation. Unfortunately, you can't because § 1091 disallows any loss if, within 30 days of a sale (before or after), the taxpayer acquires "substantially identical" stock. The disallowed loss is added to the tax basis of the purchased stock.

In Revenue Ruling 2008-5, the I.R.S. is plugging a perceived loophole where a taxpayer sells stock at a loss, buys it in his IRA, and takes the position that the wash sale rule doesn't apply because his IRA – and not the taxpayer personally – bought the stock. In short, the I.R.S. said the rule does apply. Furthermore, the disallowed loss cannot be added to the tax basis of the stock purchased in the IRA as it would be in any other wash sale. In other words, the denied loss is permanent.

Character of Income

Womack v. Commissioner, 100 A.F.T.R. 2d 2007-7103

Taxpayers win the Florida lottery and receive several annual installments which they report as ordinary income. When, in 1999, Florida law changes to allow lottery winners to assign the right to their annual payments, Taxpayers sell their right in exchange for a lump sum. Taxpayers report the proceeds from the sale as capital gain rather than ordinary income. The Tax Court determines and the Eleventh Circuit Court of Appeals affirms that lottery payments are not a capital asset under § 1221 but are ordinary income and therefore, under the substitute for ordinary income doctrine, the sale of those lottery payments is not a sale of a capital assets but is ordinary income.

S Corporations – Disproportionate Distributions

Private Letter Ruling 2008-02-002 (January 11, 2008)

S corporations can only have one class of stock, and each share must have identical rights to distributions. Differences in voting rights among shares of stock are disregarded, but disproportionate distributions among shareholders can cause the S election to terminate. In this ruling, three S corporation shareholders actually received disproportionate distributions, but the corporation later made "corrective distributions" such that all shareholders received proportionate amounts on a cumulative basis. The Service rules that the corporation can continue to be treated as an S corporation provided the corrective distributions cause cumulative distributions to all shareholders to be proportionate.

This ruling serves as a good reminder that S corporations must be careful when transferring life insurance policies to shareholders. If a company-owned policy is transferred to an insured as an employee bonus, there is no requirement that bonuses be equal. However, if the policy is

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transferred as a shareholder distribution, it must be proportionate to distributions to other shareholders.

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- To comply with Circular 230

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