August 29, 2003

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A SELECTIVE REVIEW OF THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003

On May 28, President Bush signed the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Act). The substantive changes made under the Act are relatively straightforward, and include tax relief for both individuals and businesses.

Once again, however, Congress has created a complicated maze of effective dates and sunset provisions. The Act modifies several provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The Act does not apply to tax years after December 31, 2008, when tax laws revert to their status under EGTRRA. Recall, however, that the provisions of EGTRRA do not apply to tax years after December 31, 2010, at which time the changes revert to their 2001 status. Sound confusing? It is.

The following selective summary clarifies the Act's provisions and sorts out which rules apply each year, incorporating the relevant provisions of EGTRRA. For a more detailed discussion of EGTRRA, please see *Advanced Planning Letter No.* 178 (July 6, 2001).

Equally notable, by their absence, are the political hot topics not addressed by the Act. Specifically, estate and gift tax repeal or reform, charitable giving, corporate owned life insurance, nonqualified deferred compensation, and change in the taxation of life insurance or annuities are not covered.

Child Tax Credit

Under EGTRRA, the child tax credit is scheduled to increase gradually to $1,000 per child by 2010. The Act provides that the credit will be $1,000 per child for 2003 and 2004 and that the amount of the increase for 2003 ($400 per child) be paid by October 1, 2003 based on 2002 eligibility for the credit. The credit, however, reverts to EGTRRA levels for the years 2005 through 2010. EGTRRA's sunset provisions will return the credit to 2001 levels in 2011 and after. The amount of the child tax credit is as follows:

Year	Child Tax Credit
2003-2004	$1,000
2005-2008	$700
2009	$800
2010	$1,000
2011 and after	$500

Comments: First, a credit is a particularly valuable tax reduction tool in that it reduces the *tax due* dollar for dollar. A deduction, on the other hand, merely reduces the *amount of income* subject to tax. Second, remember that the child tax credit is phased out at higher income levels. A married couple filing jointly will have no child tax credit when their combined income reaches $130,000.

Marriage Penalty Relief

EGTRRA made attempts to lessen and eventually eliminate the so-called marriage penalty — the disadvantages inherent in our tax system for married couples filing joint returns when compared to two single people filing separate returns — by gradually increasing the income limit for the 15 percent bracket and by increasing the standard deduction for joint filers.

Fifteen Percent Bracket. The Act provides that the income limit for the 15 percent bracket for joint filers is 200 percent of the limit for the 15 percent bracket for single filers for 2003 and 2004 (rather than in 2008 under EGTRRA). In 2005, the ratios revert to those under EGTRRA. In 2011, the sunset provisions of EGTRRA apply and the differential will revert to 2001 levels. The 15 percent bracket limits for joint filers compared with those for single filers are as follows:

Year	15 percent bracket limit ratios
2003-2004	200 percent
2005	180 percent
2006	187 percent
2007	193 percent
2008-2010	200 percent
2011 and after	167 percent*

Standard Deduction. As with the 15 percent bracket, the Act provides that the standard deduction for joint filers is twice the standard deduction for single filers for 2003 and 2004 (rather than in 2009 under EGTRRA). In 2005, the ratios revert to those under EGTRRA. In 2011, the sunset provisions of EGTRRA apply and the differential will revert to 2001 levels. The standard deduction for joint filers compared with standard deduction for single filers is as follows:

Year	Standard deduction ratios
2003-2004	200 percent
2005	174 percent
2006	184 percent
2007	187 percent
2008	190 percent
2009-2010	200 percent
2011 and after	167 percent*

* These ratios were determined by comparing the actual 15 percent bracket limits and standard deductions for joint filers versus single filers for 2001.

Comment: While this is a step in the right direction, the marriage penalty is far from eliminated. Changes in the standard deduction don't benefit those couples who itemize their deductions. In addition, the bracket parity only applies to the 15 percent bracket.

Married couples in higher marginal brackets continue to be at a disadvantage when compared with their unmarried counterparts.

Individual Income Tax Rates

EGTRRA provides some income tax relief for individual taxpayers in the form of lower rates and higher AMT exemptions. The Act accelerates several of those provisions.

Ten Percent Rate. The increase in income limits for the 10 percent bracket from $12,000 to $14,000 for joint filers, scheduled for 2008 under EGTRRA, will now take place in 2003 and 2004. Beginning in 2005, the limits under EGTRRA will apply. The 10 percent bracket limits are as follows:

Year	10 percent bracket limit
2003-2004	$14,000
2005-2007	$12,000
2008-2010	$14,000

Comment: In 2011, the sunset provisions of EGTRRA cause the 10 percent bracket to revert to a 15 percent bracket with 2001 bracket limits in effect. The reversion to pre-EGTRRA is even worse than it appears. Not only does the rate increase to 15 percent and return to a $12,000 bracket limit, but considering the time value of money, the reversion to pre-EGTRRA levels in 2011 amounts to a significant tax increase.

Individual Income Tax Rates. In addition to the changes to the 10 percent bracket limits, the Act accelerates the individual income tax rate reductions scheduled to take place in 2006 under EGTRRA. Beginning in 2003, the rates are 25 percent, 28 percent, 33 percent and 35 percent. These rates remain in effect until the sunset provisions of EGTRRA take effect in 2011.

Alternative Minimum Tax. The Act increases the individual AMT exemption amounts for 2003 and 2004 as follows:

married filing jointly or surviving spouse	$58,000 (up from $49,000)
non-married individual	$40,250 (up from $35,750)

Under EGTRRA, for 2005 and after, the exemption amounts revert to 2001 levels. The Act makes no change to this provision.

Comment: While this looks like all good news, consider that many states may consider increasing state and local taxes to ease their fiscal problems. Because state and local taxes (although deductible for regular tax purposes) are not deductible for individual AMT, more people may find themselves owing AMT.

Capital Gains Tax Rate Reduction

The Act provides for the following long-term capital gains rates:

Years	Rates
2003-2008	The 10 percent rate is reduced to 5 percent; the 20 percent rate is reduced to 15 percent. In 2007, the 5 percent rate is reduced to zero.
2009-2010	Rates return to pre-Act status at 10 percent and 20 percent.
2011 and after	No change from prior year because EGTRRA does not affect capital gains tax rates.

Comments: The downward spiral of long-term capital gains rates continues. As recently as the early 1990s, the top rates for ordinary income and long-term capital gains rates were identical. The latest change is the third major drop for capital gains since then (31, 28, 20, and now 15 percent), and compares favorably to the top ordinary rate of 35 percent for 2003. The 28 percent rate stays in place under the Act for collectibles and Section 1202 gain from the sale of certain small business stock.

In addition to lowering rates, the Act repeals the 18 percent bracket, which generally applied to property held for 5 years and bought after 2000. Oddly enough, taxpayers were "permitted" to treat appreciated property as though it were sold and taxed during 2000 in order to trigger the beginning of the 5 years – in hindsight, a bad choice had it been taken, unless the taxpayer sells the property after 2008.

The Act contains no requirements concerning when the property must have been purchased to qualify for the new long-term capital gains tax rates, as long as the property meets the required holding period of more than one year. It does, however, state that with respect to sales that occur in 2003, the new rates are available only on or after May 6. The total capital gains tax for 2003 is calculated using the old rates for pre-May 6 sales.

Dividend Tax Relief for Individuals

The Act lowers the tax rate on dividends received by an individual from certain domestic and qualified foreign corporations from ordinary income rates to capital gains rates. Under this provision, dividends are taxed as follows:

Years	Rates
2003-2008	Dividends are taxed at 5 percent and 15 percent rates. In 2007, the 5 percent rate drops to zero. The May 6, 2003 transition rules for capital gains do not apply to dividends received this year.

2009-2010	Rates return to pre-Act status as ordinary income (the top ordinary rate for these years is 35 percent under EGTRRA).
2011 and after	Dividends are still taxed as ordinary income, but revert to pre-EGTRRA rates (39.6 percent maximum).

Comments: This provision is the outcome of the President's attempt to repeal the individual tax on corporate dividends that originate from income that was already taxed to the entity. It differs from the President's proposal in two respects. First, the tax is never repealed in its entirety for most investors. The 2007 rate-lowering to zero percent only applies to income that would have been taxed at 5 percent, but leaves the remaining 15 percent tax rate intact. Second, the goal of taxing income only once is not realized, because the tax relief to the individual exists irrespective of whether that income was already taxed to the entity, with certain exceptions (e.g. non-profits and REITs).

The rate similarity between long-term capital gains and dividends under the Act extends to the tax calculation itself, which adds qualified dividend income to net capital gain in figuring the tax. In other words, taxpayers can climb the brackets once, not twice, in determining the amount which qualifies for 15 percent rate. This reduces the relief that is available to persons who normally owe tax on both capital gains and dividends.

Individual shareholders benefit from the dividend relief but corporate shareholders are not affected. Under the existing law, however, corporations can exclude up to 70 percent of dividends (or even 100 percent if received from an affiliated entity) when calculating taxable income.

For publicly traded companies, much has been said concerning the potential movement from debt to equity securities based on the new provision, and the possible shift toward dividend-paying stocks. The temporary nature of this legislation makes it difficult to predict long-term behavioral changes by public companies and investors. A more immediate consequence, however, may be felt with equity compensation arrangements for employees of public companies.

For example, owners of §83 restricted stock that pays dividends will save taxes under this provision if they made an 83(b) election. Because dividends under §83 plans are viewed as "owned" by the employee if the election is made, the lower rates will apply. In the absence of an election, however, the dividend is considered to be compensation income to the employee.

The dividend relief will also affect small businesses perhaps even more than it affects large companies. A distribution of accumulated earnings and profits inherited by an S corporation from its prior years' status as a C corporation previously would have generated tax at ordinary rates. The next few years offer an unprecedented opportunity to declare dividends that deplete this account at a relatively low tax cost. In addition, the family attribution rules that apply to C corporation and some S corporation stock redemptions become largely academic where there is parity between dividend and capital

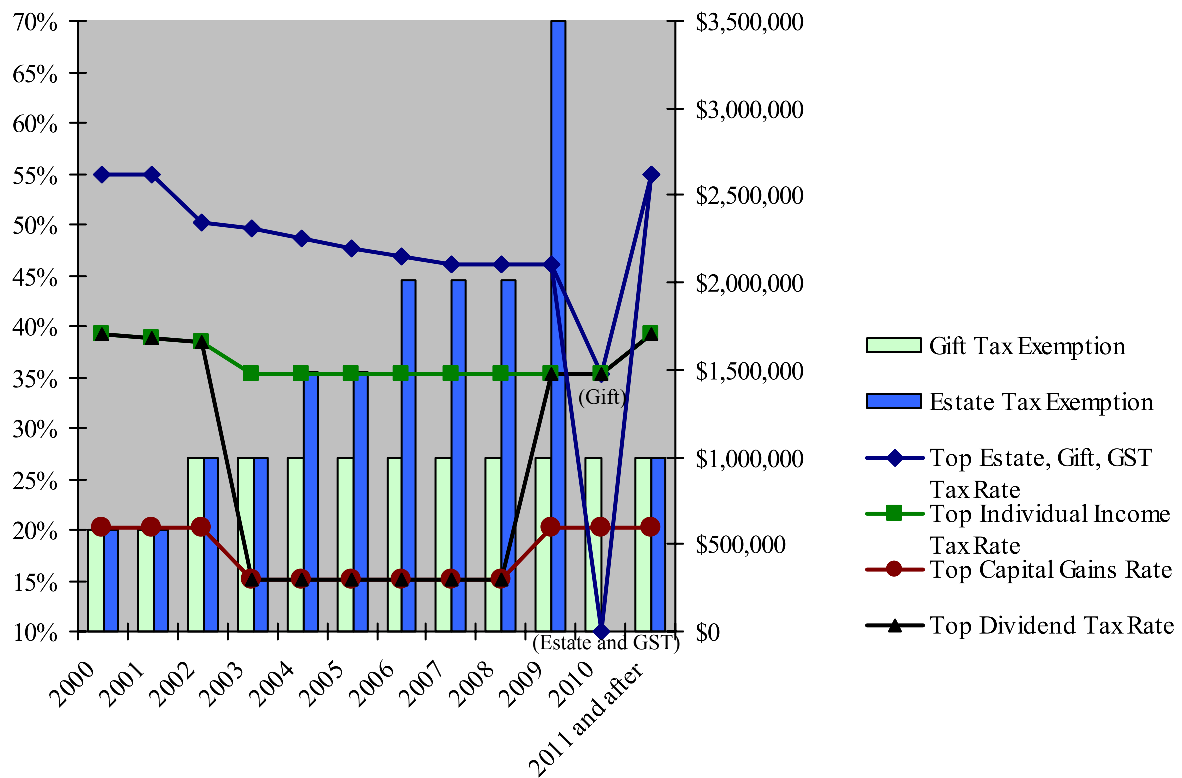
gain rates during lifetime. The capital gain and dividend relief under the Act creates these and other planning opportunities that previously were impossible or unattractive.

The Act contains several provisions this review does not address, including certain depreciation rules, section 179 expensing, state fiscal relief fund, and corporate estimated tax payments.

SUNRISE, SUNSET

It's often said that the only things that are certain are death and taxes. Although taxes are a constant in our lives, the manner in which they are imposed is anything but. In the past, Congress enacted major tax legislation every five years or so; now it is yearly. And the tax law changes have altered the core of our system by revamping the rates at which capital gains, dividends, ordinary income, gifts and estates are taxed. To add to the complexity, the changes are full of phase ins and sunsets. Are all of these changes cast in stone? Of course not. Congress will be back at it again. All of which should lead us to rethink the old adage — the only things that are certain are death and *a change in* taxes.

Since there will be future changes in taxes, the need to plan is more important than ever. But planning must be flexible enough to accommodate the shifting landscape. The inclination is to say, "Let's wait until things settle down." The chart below demonstrates that things won't settle down. The time to plan is now.



THE DAY OF THE HACKL: THE SEVENTH CIRCUIT TURNS DOWN STARRING ROLE: *Estate of Hackl v. Commissioner*, 2003 U.S. App LEXIS 13936

BACKGROUND: In April 2002, the Tax Court held that a gift of property, in this case an interest in a limited liability company, did not qualify for the annual exclusion. See *Advanced Planning Briefs* No. 46 (June 14, 2002). Most planners have anxiously awaited the Seventh Circuit's fresh look at *Hackl* on appeal. And now we know how Sally felt when the Great Pumpkin never arrived at the pumpkin patch on Halloween night: we've been sitting around for nothing.

FACTS: After his retirement, Hackl invests in tree farms and creates a limited liability company to own the farms. Hackl is the original manager of the company. In that role he has a great deal of power: the sole right to manage the entity, to decide on the amount and timing of distributions, and to determine who can withdraw from the company or sell LLC interests. Hackl and his wife give away LLC units to their 8 children and 25 grandchildren using gifts intended to qualify for the annual exclusion. The I.R.S. denies the annual exclusion, stating that the restrictions on the units make the gifts future interests. The Tax Court rules in favor of the I.R.S.; the Hackls appeal to the Seventh Circuit.

ISSUE: Was the Tax Court's opinion correct that the gifts do not qualify for the annual exclusion because the donees had no present substantial economic benefit?

RULING AND RATIONALE: Yes. As an initial matter, the Tax Court's decision is to be overruled only if it clearly erroneous. Addressing Hackl's arguments, the Court states that the definition of "future interest" in §2503(b) is ambiguous, therefore, it is appropriate to look to Treasury Regulations and case law for guidance. Under the applicable regulations and case law, the key question is whether the donees have a substantial present economic benefit. They do not.

OBSERVATIONS: The Seventh Circuit's bias against the Hackls is obvious from the first sentence of the opinion: "Most post-retirement hobbies don't involve multi-million dollar companies or land retirees in hot water with the IRS, but those are the circumstances in this case." It doesn't take much to peg the Court's take on Hackl as a rich guy trying to use his tree farming hobby to cheat the government out of revenue.

The Court's view of the taxpayer may explain the Seventh Circuit's abrogation of its responsibility to engage in an in-depth analysis of an important legal issue: does an outright gift of property to a single donee always qualify for the annual exclusion? Instead, the Seventh Circuit defers completely to, in fact parrots, the Tax Court's analysis. Why this deference to the Tax Court on a question of law? As an appellate court, the Seventh Circuit has the duty to reexamine the Tax Court's legal analysis anew.

Hackl argued that §2503(b) is unambiguous and denies the annual exclusion only to gifts of future interests, not to current, outright gifts of property. The Court rejects that argument without analysis, essentially saying that all provisions of the tax code are ambiguous, and noting that Hackl cited no cases saying that "future interest" is unambiguous. The reason that Hackl had no cases to cite to is because this is a case of first impression.

After finding "future interest" ambiguous, the Court says it was appropriate for the Tax Court to look to the regulations and case law to determine whether the gifts qualified for the annual exclusion. But does the Court analyze regulations under §2503? Does it explain how the owners of the limited liability company interests do not "possess" that property, when the regulations plainly say that a present interest exists when the donee has the unrestricted use, possession *or* enjoyment of the gifted property? No. The Court simply makes a conclusory statement: "We don't think that this language automatically excludes all outright transfers from the gift tax."

All of the cases cited by the Seventh Circuit, like the case relied upon by the Tax Court, involve situations where the transfer is not made to a person, but rather to an entity. Because the donees (the owners of the entity) have no right to use, possess or enjoy the transferred property, the gift is not one of a present interest. But the facts of the *Hackl* case are clearly distinguishable. The children and grandchildren could, at the very least, possess the limited liability company interests that were given to them. The Court offers no explanation.

This *Hackl* opinion is disappointing. With an important legal issue in the balance, the planning world rightly expected more. But at the end of the day, it is so easy to plan around this opinion, that it may be much ado about nothing. Dad and Mom give the children cash, which qualifies for the annual exclusion. Then the children purchase the interests, at their fair market value, from Dad and Mom. Maybe the annual exclusion isn't dead after all.

SECURED CREDITORS OF BANKRUPT EMPLOYER DENIED A SECURED RIGHT TO RABBI TRUST ASSETS: *Bank of America v. Moglia,* 2003 U.S. App. LEXIS 10913 (June 2, 2003)

FACTS: Outboard Marine Corporation ("Outboard") is in Chapter 7 bankruptcy and $14 million of its assets are held in a rabbi trust to informally fund a deferred compensation plan for its executives. Bank of America, as the agent of Outboard's secured creditors, claims a security interest in these assets based on its security agreement. The security agreement covers all of Outboard's "general intangibles," which include the assets in the rabbi trust. However, the bankruptcy trustee, as a representative of the general creditors, claims the assets in the rabbi trust are not subject to the "blanket" security agreement.

The bankruptcy court, seconded by the district court, holds in favor of the bankruptcy trustee's position that the rabbi trust assets are not subject to the secured creditors' security agreement. Creditors appeal.

ISSUE: Are the assets in the rabbi trust subject to the security agreement of the secured creditors?

RULING AND RATIONALE: No. The rabbi trust agreement expressly forbids Outboard to create a security interest in favor of the executives, or *of any creditor*. The rabbi trust makes clear that the trust assets are reserved for Outboard's unsecured creditors. Moreover, since the secured creditors are sophisticated, they should have known that the words, "general creditors" in a rabbi trust based on the I.R.S. Model Rabbi Trust means "unsecured creditors."

The language of the security agreement does not specify what assets are included as security. One must look beyond the security agreement "to determine what assets the agreement does include." The express language of the rabbi trust excludes its assets from the security agreement.

The rabbi trust was funded *before* the security agreement was executed between Outboard and the secured creditors. If the rabbi trust had been funded after the execution of the security agreement, Outboard's contribution of assets to the trust would have been subject to the security agreement regardless of the terms of the trust. Outboard could not impair the bank's security interest by putting some of the assets covered by the agreement into a trust that the bank could not reach.

Bank of America made two additional arguments for the secured creditors to obtain a priority interest in the assets of the rabbi trust: (1) The rabbi trust's antiassignment language is invalid, and (2) The trustee of the rabbi trust is an "account debtor" of Outboard. The Court states that the circumstances in this case "weigh heavily in favor of enforcing the antiassignment provision" and that the "account debtor" argument was "thoroughly frivolous."

OBSERVATIONS: Although the secured creditors cannot directly reach the assets within the rabbi trust under their security agreement, this does not mean that these creditors have no right to assert a claim against the trust assets in their status as unsecured creditors. In other words, the rabbi trust does not govern the final disposition of the property of an estate of a bankrupt company. The final rights of the secured creditors, if any, to the assets of Outboard's bankruptcy estate still needs to be decided by the Bankruptcy Court.

The Court, in dictum, raises the possibility that a rabbi trust can be drafted to benefit secured creditors, except employees who are secured creditors of the corporation. While legal counsel can consider the Court's suggestion, this suggested change does not exactly follow the I.R.S. Model Rabbi Trust agreement, which was designed by the I.R.S. to provide tax certainty.

ONE STEP, TWO STEP — WALTZING THROUGH THE STEP TRANSACTION DOCTRINE: *Brown v. United States*, 91 AFTR 2d 2003-2085 (May 1, 2003)

FACTS: Willet Brown's estate plan calls for his estate (about $180 million) to pass to a marital trust for his wife, Betty. Willet also creates a life insurance trust, which purchases life insurance on Betty's life. Neither Willet nor Betty are beneficiaries of the trust. To fund the life insurance trust, Willet gives Betty a check for $3.1 million. Betty deposits this into her separate checking account and immediately issues a check for $3.1 million to the insurance trust. Willet and Betty report the gift and elect gift-splitting.

The Browns' attorney advises that Betty (age 71), rather than Willet (age 87), should pay the gift tax. Because Betty has few assets of her own, Willet gives Betty two checks totaling exactly the amount of the $1.4 million gift tax due. Betty deposits these checks into her separate account and, the next day, issues two checks payable to the I.R.S. for the gift tax.

Willet dies within three years of the payment of the gift tax. His estate tax return shows no tax due. The I.R.S., however, asserts an estate tax deficiency, arguing that Willet was the payor of the $1.4 million of gift tax, and includes the $1.4 million in Willet's estate because he died within three years of the payment of the tax.

ISSUE: Should the two transactions – Willet's gift to Betty and Betty's payment of the gift tax – be collapsed into one transaction of Willet paying the gift tax?

RULING AND RATIONALE: Yes. Willet is considered to have paid the gift tax within three years of his death, and the gift tax is included in his gross estate under the 1993 predecessor of §2035(b). Because this is a gift to the insurance trust, no marital deduction is available, and estate tax is due.

The estate tried to eliminate any estate tax due on the gift tax included in the estate by claiming additional administration expenses. These expenses, however, were paid from assets qualifying for the marital deduction, which reduces the marital deduction. The decrease in the marital deduction increases the taxable estate, which makes elimination of the tax impossible.

The step transaction doctrine is a subset of the "substance over form" concept. The doctrine stands for the proposition that multiple, contrived steps to achieve what a single act will accomplish should be collapsed into one step, which provides a more realistic view of the entire transaction. However, it is also well established that taxpayers can arrange their affairs so that taxes will be as low as possible. How can these competing concerns be reconciled? The Ninth Circuit looks at two principles before applying the step transaction doctrine to collapse the transactions – first, tax avoidance versus tax evasion, and second, the scope of the statute involved (§2036).

Tax Avoidance versus Tax Evasion
The Court characterizes the transactions as illegitimate tax evasion rather than legitimate tax avoidance. According to the Court, the gift to Betty had no, or minimal, purpose beyond its effect on tax liabilities. The only purpose for transferring funds to Betty was to camouflage Willet's payment of the gift tax. Since Betty is only a conduit, her role is ignored.

The fact that Betty has no legal obligation to complete the arrangement – to use Willet's gift to pay the gift tax – does not negate the use of the step transaction doctrine. Betty, although not legally obligated, is likely to follow through with Willet's wishes; in fact, Betty benefits because the estate tax as a result of the gift tax inclusion would have – and indeed, now will – come from the assets passing to the marital trust for her benefit.

Scope of the Statute
The opinion analyzes whether the facts fall directly within the intended scope of §2035(c). Under this section, Willet's estate is required to include any gift taxes he paid within three years of death on any gift made by either Willet or Betty. The purpose is to restore Willet's net worth to what it would have been if he hadn't paid a gift tax. As a result, the source of funds is important. If Willet provides the funds, his gross estate is increased; if Betty provides the funds, Willet's gross estate is not increased. Willet paid the taxes by using Betty as a "contrived step" to obtain tax treatment different than if Willet had paid the tax directly.

The I.R.S. admits that if Betty had died within three years, it would have included the gift taxes paid in her estate. Although troubled by this, the opinion does not address the issue since it was not before the Court.

OBSERVATIONS: The step transaction doctrine was originally applied in an income tax case but has been used in the transfer tax arena. Does the step transaction doctrine have an impact on estate planning? While the holding in this case is fact-specific, and not likely to apply in many other instances, be on the lookout for situations where an outcome not attainable in one step is attempted in two (or more) steps.

But what does this case teach us about how to avoid having a series of steps in a transaction characterized as one? Willet and Betty should have disconnected these transactions. First, Willet could have made a gift to Betty that was different in amount from the gift tax due. Second, the time between the gift and the payment of the gift tax could have been longer — the longer, the better.

The moral of the story: difference, in time and amount, might make all the difference in avoiding the step transaction doctrine.

TAXPAYER WINS FIRST BROAD-BASED LEVERAGED COLI CASE:
***Dow Chemical Company v. U.S.*, 91 AFTR 2d 2003-1489 (March 31, 2003)**

Alert: Upon reconsideration, the U.S. District Court for the Eastern District of Michigan upheld its decision in Dow Chemical v. U.S., 91 AFTR 2d 2003-1489, 250 F. Supp.2d (March 31, 2003).

FACTS: Dow Chemical Company ("Dow") buys corporate owned life insurance ("COLI") policies on the lives of 4,051 upper management employees in 1988 and policies on the lives of 17,061 employees in 1991. The premiums are financed by using an elaborate plan to borrow from the insurance company to pay the premiums in the first three years and the eighth year of the policy. All loans are secured by the accumulated cash values of the policies. The premiums in years four through seven are paid through partial cash withdrawals of the policy cash values. Under this leveraged COLI plan, Dow drastically minimizes its initial cash outlay for the premium payments.

The government claims that Dow's leveraged broad-based COLI plan (sometimes called "janitor insurance") has no practical economic purpose apart from generating the tax deductions for the interest payments and therefore is a "sham in substance." This claim is similar to one that the government used when it successfully litigated three other cases involving leveraged broad-based COLI plans. See *Winn-Dixie Stores, Inc., et. al., v. Commissioner* 87 AFTR 2d 1001; *In re CM Holdings, Inc.,* 90 AFTR 2d 2002; and *American Electric Power, Inc. v. U.S.*, 91 AFTR 2d 2003.

Moreover, the government contends that the individual life insurance issued on the lives of upper management employees should be recharacterized as group insurance because the policies "possess many of the traits commonly seen in group contracts." The government also argues that Dow had no "insurable interest" on these employees as defined under Michigan law, so that the policies are not "life insurance." If the policies are not life insurance under state law, Dow cannot defer tax on the inside build up, or deduct the interest paid on policy loans.

In addition, the government claims that the "netting transactions" (the payment of the premiums, and the loans and withdrawals occurred simultaneously on the first day of each anniversary) are factual shams which cause the plan to fail the four-out-of-seven rule under §264(d)(1).

For all these reasons, the government denies interest deductions and related expenses that Dow claimed in 1989, 1990 and 1991. The income tax deficiencies, together with interest, total $22,209,570.

ISSUE: Can Dow deduct the interest on the policy loans?

RULING AND RATIONALLE: Yes. The plan has economic substance and is not just a plan to generate tax deductions. Dow has a real business purpose for the COLI policies: to defray the future costs associated with its unfunded employee retirement medical benefits. Dow also did an exhaustive legal and tax analysis of various COLI

policies before selecting the COLI policies used in their plan. In fact, Dow selected COLI policies that are designed differently than the COLI policies in *Winn-Dixie, In re CM Holdings, Inc.* and *American Electric Power, Inc.* For example, Dow's policies did not have (1) unconventional "loading dividends" to pay premiums, (2) artificially high loan interest rates to supercharge the crediting rate on borrowed funds and (3) 100% "retrospective" mortality payment mechanism to eliminate past risk transfer. In addition, Dow's pre-purchase illustrations showed positive cash flow without income tax deductions. Accordingly, Dow's plan is not a "sham in substance."

The "netting transactions" in years four through seven to pay premiums are "shams in fact," but the four-out-of-seven rule under §264(d)(1) is satisfied because this tax rule does not require that level premium payments be paid. In addition, the use of "netting transactions" does not make loans a sham.

Lastly, under Michigan insurance law, Dow has an insurable interest on the lives of the upper management employees covered under its 1988 COLI plan; therefore the policies are life insurance under state law for federal tax purposes under §7702(a). Also, there is no basis for recharacterizing of the upper management policies as group insurance.

OBSERVATIONS: *Dow* is appealable to the Sixth Circuit Court of Appeals, the same Circuit that affirmed *American Electric Power, Inc*. The Sixth Circuit ruled that American Electric Power's COLI plan is a "sham in substance." If the government appeals the *Dow* case, time will tell whether the factual differences noted in *Dow* will be sufficient for the Sixth Circuit to uphold Dow's plan. If the District Court's decision is upheld on appeal, it could raise a conflict with other Circuits, namely the Third Circuit (the *In re CM Holdings, Inc*. case) and the Eleventh Circuit (the *Winn-Dixie Stores, Inc*. case). However, if *Dow* is upheld on appeal, it may have limited precedential value because the facts in *Dow* are unique.

These janitor insurance cases are not sold today because Congress changed the tax laws in 1996 to limit interest deductions for policy loans under these plans. To address pre-1996 COLI cases, the I.R.S. is denying the interest deduction on these broad-based leveraged COLI plans by arguing that they are "shams." At this point, the government has successfully litigated all cases except *Dow*.

For additional information about *Winn-Dixie* and *In re CM Holdings, Inc.*, see *Advanced Planning Briefs* Nos. 42 (November 9, 2001) and 52 (January 10, 2003).

CHURNED AND BURNED:
***Meyer v. Berkshire Life Insurance Company,* 250 F. Supp. 2d 544 (D. Md. 2003)**

FACTS: Two doctors ("Doctors") hire Berkshire Life Insurance Company to manage their qualified retirement plans. Berkshire charges no fee to manage the plans; instead it requires each plan to invest a minimum percentage of contributions in life insurance (25% for one plan and 30% for the other). The Berkshire agent ("Agent") claims he is a financial advisor, but lacks financial planning experience, training, certifications, and a college degree. Agent predicts each plan's value will increase from approximately $280,000 to $2,000,000 by each Doctor's retirement. Agent develops and implements investment recommendations with no input from the Doctors. Doctors regularly sign blank forms that Agent later completes. The plans' overall rates of return while managed by Berkshire (1983 – 1996) are 2.85% and 3.71%.

ISSUE: Has Berkshire mismanaged Doctors' retirement plans, and if so, is Berkshire liable under ERISA?

HOLDING AND RATIONALE: Yes. Berkshire's mismanagement is a breach of its duties under ERISA and the cause of the losses to the plans.

Berkshire failed to diversify. Berkshire admits the investments were not diversified and that it neither developed an investment strategy nor discussed one with Doctors. The Agent admits to the Court his approach is unduly conservative, but failed to say so to Doctors. For twelve of the fourteen years, conservative income products made up 90% of the plans' assets. This is a breach of Berkshire's duty to diversify plan assets. ERISA §1104(a)(1)(C).

Berkshire overloaded the plans with life insurance, which caused unacceptably low rates of returns

Berkshire churned the assets. Agent acted imprudently by rapidly changing the plans' life insurance and annuities to generate commissions, which caused a reduced rate of return because of the substantial commissions and surrender charges. Agent failed to disclose to Doctors the costs and charges of each transaction.

Berkshire's overloading and churning are breaches of its duties to act prudently and in the Doctors' best interests. ERISA §§1104(a)(1)(A) and (B). Berkshire did not consider Doctors' circumstances, as required by the Department of Labor. 29 C.F.R. §2550.404a-1(b)(1)(i). For example, Berkshire failed to assess each Doctor's personal situation and need for life insurance. Had it done so, it would have known that one Doctor was single with no children and did not need the life insurance Berkshire required. Further, churning the life insurance and annuities to increase compensation was not in Doctors' best interests.

Berkshire is vicariously liable for Agent's conduct because it was an ERISA fiduciary as to Doctors' plans, and as Agent's employer, Berkshire controlled Agent's conduct and therefore controlled the plan assets.

OBSERVATIONS: The mere use of life insurance in Doctors' retirement plans is not the problem. In many cases, it is a smart use of retirement plan funds. However, Berkshire and its Agent made three mistakes that lead the court to find breaches under ERISA. First, Berkshire allowed an incompetent Agent to act as a financial advisor. Second, Agent failed to identify and monitor the clients' investment objectives, risk tolerance and need for life insurance. Third, Agent churned the policies.

Let's not overlook Doctors' lack of involvement and responsibility for their own affairs. The plans included their employees' retirement savings, and each Doctor was his plan's trustee. While they were not on trial in this case, they should have been more diligent.

ARE YOU EXPERIENCED? HENDRIX LIVES – BUT YOUR 419 PLAN IS DEAD: Treasury Decision 9046 (July 17, 2003)

BACKGROUND: Whenever employers fund any deferred benefit for employees, the Code treats it as deferred compensation. §404(b)(2)(A). Both qualified and nonqualified deferred compensation, however, are boring to those owner-employees who want large current business deductions without current income tax. The only way to escape the deferred compensation rules is to pre-fund welfare benefits – disability, medical, severance, life insurance – subject to §§419 and 419A. §404(b)(2)(B).

If contributions to a welfare benefit fund are deductible under another Code section, the §419 rules allow a current deduction without simultaneous income, but impose low contribution limits. An exception to the contribution limits exists for 10-or-more-employer plans as long as they are not "experience-rated." §419A(f)(6). Because experience-rating was never clearly defined, promoters of so-called "419 plans" have heavily marketed – and generally abused – this exception by claiming to provide unlimited deductions with no income tax until plan assets are later transferred to employees. An additional siren song has been that the owner-employee can control the event purportedly triggering payout to the employee: the employer "severs" the employee (*i.e.*, owner fires himself) or simply terminates participation in the plan. In other words, this type of 419 plan is an artifice contrived to camouflage an illegitimate deferred compensation plan under the guise of an ostensibly innocent "welfare benefit plan." This is how these plans have been designed, promoted, and sold – and why they have been purchased.

Periodic attempts to quell this abuse have come through notices, litigation, and tax shelter disclosure regulations. *See, e.g.*, Notice 95-34; *Booth v. Comm'r*, 108 T.C. No. 25, (1997); *Neonatology Associates v. Comm'r*, 299 F.3d 221 (3rd Cir. 2002); and Treas. Reg. §1.6011-4. Treasury issued proposed regulations last year clarifying that the exception is narrow. *See Advanced Planning Briefs* No. 47 (July 18, 2002). Treasury has now finalized these regulations with few changes, administering the final blow to these dubious plans.

FINAL REGULATIONS: An employer's welfare benefit plan is experience-rated – making it ineligible for the 10-or-more employer exception – if the employer's contributions or any benefits are based on the benefit experience of that employer or its employees, or on the growth experience of the contributions from that employer or its employees. The regulations list five incriminating characteristics that create the presumption of experience-rating, any one of which cases failure unless the plan administrator rebuts it to the satisfaction of the Service. The absence of these characteristics, however, does not mean the plan is not experience-rated.

1. *Allocation of plan assets.* Assets of the plan or fund are allocated to a specific employer or employers, for example, through separate accounting of contributions and expenditures for individual employers.

2. *Differential pricing*. The amount charged under the plan is not the same for all the participating employers, and those differences are not merely reflective of differences in current risk or rating factors that are commonly taken into account in manual rates used by insurers (such as current age, gender, geographic locale, number of covered dependents, and benefit terms) for the particular benefit being provided.

3. *No fixed welfare benefit package.* The plan does not provide for fixed welfare benefits for a fixed coverage period for a fixed cost. To be a fixed benefit, the amount of the benefit must not depend on the amount or type of assets held by the fund.

4. *Unreasonably high cost.* The plan provides for fixed welfare benefits for a fixed coverage period for a fixed cost, but that cost is unreasonably high for the covered risk for the plan as a whole.

5. *Nonstandard benefit triggers.* Benefits or other amounts payable can be paid, distributed, transferred, or otherwise provided from the plan by reason of any event other than the illness, personal injury, or death of an employee or family member, or the employee's involuntary separation from employment.

There are special rules for life insurance, and the regulations warn that promotional materials and policy illustrations can establish experience-rating even if formal plan documents do not. Treas. Reg. §1.419A(f)(6)-1(a)(3). Examples in the regulations also show that funding plans with individual policies may cease altogether, even though use of individual life insurance policies is theoretically allowed. Some examples are summarized below:

Whole Life. Employer X and Employer Y participate in a death benefit plan. Starting in year 2000, Employer X annually contributes an amount equal to the level premium for a whole life policy (in fact purchased by the plan) on its 50 year-old employee, and this continues through 2005 when that employee is age 55. Starting in 2005, Employer Y also annually contributes an amount equal to the level premium for a whole life policy (in fact purchased by the plan) on its 55 year-old employee. Because the policy covering Employer Y's employee has an issue age of 55 and not 50, its level premium is greater than the policy covering Employer X's employee, and the policies have different cash values. The plan exhibits three incriminating characteristics: it allocates plan assets to specific employers; it exhibits differential pricing because the different amounts charged are due to different issue ages and not *current* risk or rating factors; and the amounts charged in the early years are unreasonably high to provide the covered risk. See Example 4 of Treas. Reg. §1. 419A(f)(6)-1(f).

Term. If the employers above instead fund their plans with level term policies, the plan still exhibits two incriminating characteristics: it allocates plan assets to specific employers; and it exhibits differential pricing because the different amounts charged are

due to different issue ages and not current risk or rating factors. See Example 5 of Treas. Reg. §1. 419A(f)(6)-1(f).

Universal Life. Assume the plan above instead purchases universal life policies providing death benefits that are a certain multiple of salary, and the premiums (*i.e.*, employer contributions) are double the current mortality and expense charges. The excess premium increases cash values, and when an employer terminates participation in the plan, the policies are distributed to that employer's covered employees. This plan exhibits three incriminating characteristics: it allocates plan assets to specific employers; it does not provide for fixed welfare benefits for a fixed coverage period for a fixed cost because the amount of the withdrawal benefit (value of the policies) is unknown; and it provides for a nonstandard benefit trigger because terminating participation does not qualify as an *involuntary* separation from employment. See Example 13 of Treas. Reg. §1. 419A(f)(6)-1(f).

Group rates. Here is one that works. Employers X and Y participate in a welfare benefit plan providing death benefit equal to a certain multiple of salary. The employer contributions are equal to the Table I rates under §79, and no type of benefit or conversion feature will ever be distributed to any employee or employer. See Example 7 of Treas. Reg. §1. 419A(f)(6)-1(f).

EFFECTIVE DATE: The regulations technically are effective for contributions paid or incurred in taxable years of an employer beginning on or after July 11, 2002. The regulations' preamble also states that because they are clarifying existing law, taxpayers should not infer that a contribution that is not deductible under the regulations is deductible if made before the effective date. So, if your 419 plan is experience-rated under these regulations, your plan was experience-rated as soon as you entered into it years ago. If you bought during a fire sale, you got burned.

OBSERVATIONS: The final regulations stomp out virtually every 419 plan we've ever seen, and induce the following comments.

Involuntary separation from employment. The definition of "nonstandard benefit triggers" specifically prevents a favorite device of 419 plan participants: retiring business owners withdraw from the plan as the employer, and the plan distributes assets to them as individual employees. Treas. Reg. §1.419A(f)(6)-1(c)(6). The regulations do not attack specifically the technique of business owners firing themselves. But in the unlikely event this is seen as involuntary employment termination, any distribution of plan assets to "severed" employees would nonetheless fail the allocation of plan assets test. (See universal life example, above).

Unreasonably high cost. Examples show that premiums on whole life and universal life policies are probably too high, but that term and §79 group rates seem acceptable. There's no mention of Table 2001 rates, used for split dollar and qualified plans. Promoters may be tempted to label king-size contributions as term rates, but the room for abuse here is slight. Although employees can exit a plan with a right to convert group

insurance to individual coverage, having a conversion right to any additional economic value is a nonstandard benefit trigger. Treas. Reg. §1.419A(f)(6)-1(c)(6).

Employee-owned policies. The special life insurance rules clarify that any insurance contracts "under the arrangement" are considered *assets of the plan*. What's more, any payments to the insurer by the employer or employee are treated as contributions to the plan, and any distributions from policies are treated as distributions from the plan. Treas. Reg. §§1.419A(f)(6)-1(b)(4)(i)(A) and (B). Adding these rules to the "unreasonably high cost" characteristic should kill any advantage that certain death benefit only plans pretend to have, where the *employee owns the policy* and endorses/assigns death benefit to the plan using a trumped-up one-year term cost that approaches the entire premium of the cash value policy. The exaggerated price of this supposed death benefit coverage is made more obvious when the plan endorses the same death benefit back to the employee, but charges nothing more than Table 2001 rates. Even before these regulations, Notice 2002-59 barred any rate greater than Table 2001, and *Neonatology* imposed current tax on the individual owners in a similar scenario. This approach ultimately is stained by the same sin as "reverse split dollar" – it is not disguised deferred compensation, but instead is disguised *current* compensation.

What to do now? There is no perfect way to extract yourself from a 419 plan, but just as heroin dealers probably do not give the best advice on how to kick the habit, 419 plan promoters are not the most reliable source for exit strategies. In any event, cease contributions to the plan. Honest taxpayers will amend their returns and pay back taxes and interest. That's easier said than done. Should the employer reduce its deduction? Or should the employee include plan contributions in income? Or both if the contribution was really a dividend?

Any transfer of the policy to the employee will be income and subject to tax. It can get much worse, however, because the distribution to the employee may be seen as first a reversion to the employer, and then a payment to the employee. If treated this way, there is an excise tax on the reversion. §4976. And the rate of this tax is a brutal 100%! Who pays this potential tax is something the participant's counsel will want to discuss with the plan promoters when negotiating any termination or continuance of the relationship. Lastly, there is no inherent reason to exchange the old policy for a new policy, unless the old contract is performing poorly or will fall apart without new contributions. Just keep in mind that Northwestern Mutual will not touch 419 plans, so first transfer the policy out of the plan before exchanging to us.

Invalid regulations? Some brazen promoters may continue business as usual, claiming the regulations are invalid. Fat chance. Congress gave Treasury explicit authority to prescribe regulations governing these welfare benefit plans. §419A(i). The Supreme Court tells us that "such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Chevron U.S.A. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984).

"Our plan still works!" Other gutsy promoters surely will say that their plan fits within the clarified rules. If true, either it is not generating a big deduction or the contributors get little on the back end – either way, not the deal employers expected. In any event, the final regulations require administrators to keep records that Treasury can inspect and copy to ensure compliance with §419. This applies to plan years beginning after July 17, 2003, but taxpayers purporting to meet this 10-or-more employer exception have had to disclose participation to the Service as a "listed transaction" for several years. See Notices 2000-15 and 2001-51; and also *Advanced Planning Briefs* No. 55 (May 9, 2003).

Disability equity trust. Several promoters push arrangements called "disability equity trusts," or "long term care equity trusts," or some similar name. They claim their plan generates a big deduction and no income tax until years later, but also claim that it is not a §419 plan, so it does not need to escape the contribution limits. Don't believe the hype. All plans providing deferred benefits are presumed to be deferred compensation, and the *only* way out of that characterization is to meet the §419 requirements. §404(b)(2)(B).

At your service. Don't forget that that the friendly folks at the I.R.S. invite reports about any improper tax avoidance transactions at this address: Internal Revenue Service LM:PFTG; Office of Tax Shelter Analysis; 1111 Constitution Ave., NW; Washington, D.C. 20224. Or if you like, you can use phone (202-283-8740), fax (202-283-8354), or e-mail (irs.tax.shelter.hotline@irs.gov).

MDRT IR Index: 2400.07, 3300.14, 6410.00, 7500.00

SHAM UNIONS DON'T GENERATE DEDUCTIONS UNDER §419:
I.R.S. Notice 2003-24, 2003-18 I.R.B. 853

BACKGROUND: We have repeatedly contended that the vast majority of §419 plans, the colloquial name for welfare benefit plans, do not deliver the tax benefits their promoters claim:

– an immediate and super-sized current income tax deduction for a business;

– no current income for the business owners; and

– the channeling of the majority of the benefits to owners as deferred compensation through a calculated plan termination or plan withdrawal.

The purported purpose of these plans is to fund welfare benefits (*e.g.*, medical coverage, death benefits, and disability and severance payments) rather than to defer compensation. If the plan funds welfare benefits, the business must meet certain requirements to receive a current income tax deduction for its contribution. First, the contribution must be an ordinary and necessary business expense. §162. Second, the contribution must meet the strict limits of §419 and §419A. To entice the employer, promoters of these plans create artifices which claim to skirt these limits.

One involves the exception for "10-or-more-employer plans." §419A(f)(6). The Service, concerned about abuses with these types of plans, made them "listed transactions" for purposes of the tax shelter regulations in Notice 2000-15, 2000-1 C.B. 826 (February 29, 2000). More recently, Treasury issued Proposed Regulations to further curb their use. See *Advanced Planning Briefs* No. 47 (July 18, 2002).

The other involves the exception for certain collectively bargained plans under §419A(f)(5). To qualify for this exception, the plan must pass certain tests:

– the benefits provided must derive from arms-length negotiations between an employee representative and the employer;

– the circumstances surrounding the collective bargaining agreement must show evidence of good faith bargaining between *adverse* parties over the benefits to be provided by the fund; and

– the plan must be a "separate" welfare benefit fund.

To pass these tests, promoters have designed arrangements where a group acting for an employer negotiates with a union or labor organization representing employees over the benefits to be provided to those employees (including, of course, the owner). If the employer has no union, the promoter makes one up and provides the employee representative (a straw man) - who acts in concert with the employer to reach the

agreement. In other cases, the employee representative may be affiliated with a legitimate union, but there is no bona fide bargaining between employees and employer.

ISSUE: Do these "collectively bargained" arrangements meet the exception to the contribution limits of §419 and §419A?

THE NOTICE: No. Any tax benefits generated by these plans are denied and are listed transactions under the tax shelter rules if:

1) the plan provides more favorable coverage for an owner than the other employees. The I.R.S. will consider the coverage to be more favorable for the owner if it has any *attributes* that are likely to result in the owner actually receiving more favorable coverage or benefits than other employees, or

2) in any year, the employer's contributions with respect to any owner, considered in the aggregate, exceed one-half of the employer's total contributions (but only if there is at least one owner with respect to whom the employer's total contributions exceed $20,000).

The Notice lists examples of collective bargaining arrangements that are denied tax deductions.

– an arrangement providing death benefits based on a uniform multiple of compensation, if it can be expected that an owner obtains other benefits, such as the right to accumulated amounts under the arrangement, that are not available on the same basis to other employees;

– an arrangement allowing loans to participants under which it can be expected that an owner is able to obtain the loans more readily, or on better terms, than the other employees; and

– an arrangement providing benefits only to participants who have completed a specified number of years of service with the employer, if it can be expected that one or more owners are the only employees to satisfy the years of service requirement.

Even if a collective bargained arrangement is not a listed tax shelter, arrangements that are the same as, or substantially similar to the arrangements described by the Notice, may be subject to other tax shelter disclosure requirements, registration requirements, or the list maintenance requirements. §§6011, 6111-6112. For a more complete discussion on tax shelter disclosure and registration requirements see *Advanced Planning Briefs* No. 55 (May 9, 2003).

Participants, promoters and advisors who fail to comply with the Notice may be subject to civil and criminal penalties.

ANALYSIS: Congress created the collective bargaining exception because it believed bona fide arms' length negotiations between adversarial parties (management and labor) that would prevent precisely the type of shenanigans seen here. The promoter's schemes do not pair true adversaries in negotiation. Consequently, there is no arms' length bargaining and no intent to benefit anyone but the owner.

OBSERVATIONS: Some promoters rely on VEBA determination letters under §501(c)(9) to lend credibility to their plans. The Notice warns this does not work; a determination letter merely determines the plan's tax status. It has no bearing on the deductibility of plan contributions or the taxation of the plan benefits.

The I.R.S. plans to publish proposed regulations under §419A(f)(5), but don't expect them to revive these plans. The Notice is yet another indication of the Service's determination to crack down on all abusive §419 plans and a strong reminder that participation, in any form, could mean costly penalties (the Notice lists 10 potential penalties!).

Like the Service's previous responses to abusive §419 plans, life insurance is singled out as a culpable component of these plans. Why? Most plans are designed so owners receive more favorable coverage through the use of cash value policies than employees, who receive only term insurance. Plus, these plans claim to offer the Holy Grail – tax deductible premiums, combined with tax-deferred growth of cash values.

ONE-HALF OF LIFE INSURANCE INCLUDED IN INSURED OWNER'S ESTATE AS COMMUNITY PROPERTY: Revenue Ruling 2003-40, 2003-17 I.R.B. 1 (April 28, 2003)

FACTS: The insured, a Louisiana resident, names himself as the sole owner and his spouse as beneficiary of a life insurance policy. Premiums are paid with community funds and at his death the proceeds are paid to the spouse.

ISSUE: What is included in the insured's estate?

RULING: One-half of the death proceeds are included. Death proceeds are included in a decedent's estate if the insured decedent holds any incidents of ownership in the policy. §2042(2). The impact of state law must be considered when determining whether any incidents of ownership exist. Treas. Reg. § 20.2042-1(c)(5). Without evidence to the contrary, Louisiana law creates a presumption of community property. *Burris v. Commissioner*, T.C. Memo. 2001-210 (August 8, 2001). See *Advanced Planning Briefs* No. 43 (January 18, 2002). Therefore, one-half of the proceeds is includible in the decedent's gross estate.

OBSERVATIONS: The Ruling reaches the right result with the right rationale. Louisiana law creates a presumption that the policy is community property. There are no facts to rebut the presumption. Therefore, one-half of the death proceeds are included in the decedent's estate. End of story.

To further clarify its position, the Service issued an Action on Decision (on the same day as this Ruling) which acquiesces, in result only, to *Burris*. This means the government agrees with the holding, but not the Tax Court's reasoning. This additional guidance may not be relied upon by taxpayers, but *Burris* can be cited as precedent, and this new Ruling can be relied upon by all taxpayers.

PLANNING TIP: What does all this mean to planners? Business as usual. Everybody knows that determining what is included in an estate can be tricky if community property law is involved. Don't rely on a rebuttable presumption to determine what each spouse owns and how much is included in each spouse's estate. Classify a policy as either community or separate property according to local procedures. Notify Northwestern Mutual of life insurance held as separate property by filing a Waiver of Community Property Form 90-1478 with the Beneficiary and Title divisions of New Business (for new policies) and Policyowner Services (for existing policies).

MDRT IR Index: 1700.00

I.R.S. DISSES WRAPERS – OWNERS OF VARIABLE INSURANCE CONTRACTS FUNDED WITH PUBLICLY TRADED HEDGE FUNDS TAXED ON INSIDE BUILDUP:
Revenue Ruling 2003-92 (August 18, 2003); Revenue Ruling 2003-91 (August 18, 2003); Proposed Repeal of Treas. Reg. §1.817-5(f)(2)(ii) and Example (3) of Treas. Reg. § 817-5(g) (REG 163974-02) (July 29, 2003)

BACKGROUND: In a recent private letter ruling, the I.R.S. found that the owner of a variable life insurance policy is the owner of private investment partnerships or hedge funds inside the policy where the funds can also be purchased elsewhere in the marketplace. Priv. Ltr. Rul. 2002-44-001 (May 2, 2002). See *Advanced Planning Briefs* No. 51 (January 3, 2003). The result is that the policy owner loses the tax deferral feature of the insurance "wrapper" and is taxed currently on the funds' earnings.

The ruling generated some controversy because it appeared to conflict with Treasury Regulation §1.817–5 (f)(2)(ii) and Example (3) of Treasury Regulation §1.817-5 (g). These provisions indicate that variable contracts invested in partnership interests (including hedge funds) that are not registered under federal or state law satisfy the look-through requirements of §817(h). The regulations do not say that the hedge fund investments must be available exclusively through the purchase of a variable contract. The regulations on their face then — and unlike the ruling which did not focus on the regulations — support extending tax deferral status to variable contracts that contain hedge funds without being conditioned on limiting ownership of the investments to policy owners.

THE NEW REVENUE RULINGS AND PROPOSED REPEAL OF REGULATIONS: The new Revenue Rulings follow the reasoning and holding of last year's private letter ruling. Moreover, controversy over the ruling's apparent inconsistency with Treasury Regulation §1.817-5(f)(2)(ii) and Example (3) of Treasury Regulation §1.817-5(g) can soon be put to rest: the Service has proposed a new regulation to repeal these regulations, to be made effective once the proposed regulation becomes final. Taken together, these administrative pronouncements make clear the Service will not permit variable contracts to be treated as life or annuity contracts (with accompanying tax deferral status) when they are invested in non-registered hedge funds or other non-registered partnership interests, unless the investments are available solely through the purchase of the variable policies.

OBSERVATIONS: The Treasury press release accompanying the issuance of the Revenue Rulings declares that they "curtail the purchase of life insurance and annuity contracts primarily for tax avoidance purposes." Other sweeping assessments will probably follow, now that the Service has also proposed repealing the regulations that appeared to carve out relief to non-registered partnership interests.

The rhetoric is a bit over-heated, for several reasons. First, the rulings involve hedge funds and other private placement investments *inside* variable contracts — which are

outside the mainstream of variable contract investments. Second, as we noted, last year's private letter ruling presaged the results in these published rulings. Indeed, going back to Revenue Ruling 81-225, 1981-2 C.B.12, and assorted other "investor control" rulings, the Service has let it be known that if the same investments that are used to fund annuity contracts are available to the general public they will be considered owned directly by the annuity purchaser. The committee reports accompanying the enactment of the diversification requirements of §817(h) endorse that position. H. R. Conf. Rep. No. 98-861 at 1055 (1984). See also Treas. Reg. §1.817-5(f)(2)(i). Third, insurers can still offer hedge funds as an investment option for variable contracts, provided that they are included in a separate fund in which the public cannot invest directly. That is a small price to pay for those investors who want to purchase variable contracts that contain hedge funds.

Despite the bad publicity, Revenue Rulings 2003-92 and 2003-91 offer some reassuring news to purchases of conventional variable life policies. They permit a policy owner to freely transfer investments among a multitude of sub-accounts (as many as 20 sub-accounts are contemplated in Revenue Ruling 2003-91) without running afoul of the "investor control" issue.

There is, however, one disturbing aspect to the Revenue Rulings: the Service rests its conclusions on §61 (the catch-all income tax section of the Code), and not §817 (the variable insurance section). Beginning with the recently proposed split dollar regulations and now with these variable contract rulings the Service seems to be adopting a "one-size-fits-all" mentality toward §61, even though reliance on more narrowly drawn statutes is available. How far will the Service take this "sledgehammer" approach? That remains to be seen, but it deserves being watched carefully. The ramifications there could dwarf concerns about how hedge funds inside variable contracts are treated.

I.R.S. PROVIDES SAMPLE DOCUMENT FOR QUALIFIED PERSONAL RESIDENCE TRUST: Revenue Procedure 2003-42, 2003-23 I.R.B. (May 9, 2003)

BACKGROUND: An individual can transfer his personal residence to a qualified personal residence trust (QPRT) for the benefit of others (children, grandchildren, *etc.*) while retaining the right to live in the home for a specified term. The value of the gift to the trust, which is calculated at the time of the transfer, is the difference between value of the residence and the value of his retained interest. Upon the expiration of the trust term, the beneficiaries receive the residence. Assuming the grantor survives until the expiration of the trust term and home values continue to rise, he can remove an asset from his estate at a reduced gift tax value.

REVENUE PROCEDURE: To be treated as a QPRT, the trust document must satisfy a number of technical requirements. See Treas. Reg. §25.2702-5(c). The Service has issued a sample document conforming to all of the requirements for a QPRT with one transferor. In addition, the Service has provided sample language for alternative and optional provisions.

OBSERVATIONS: Taxpayers are not required to use this form. The sample form, however, provides certainty that a trust document satisfies the requirements for a QPRT. If the sample is used, clients still need an attorney to customize the document.

The popularity of QPRTs generally grows with increases in the §7520 rate, which is used to determine the present value of the remainder interest. When interest rates are high, the value of the remainder interest is low. This minimizes the paper value of the gift made to the trust beneficiaries and can be an efficient use of the $1,000,000 gift tax exemption amount. However, when interest rates decline, the value of the gift increases. Because the QPRT is not gift-tax effective in a low interest rate environment, this technique is not common right now.

MDRT IR Index: 8300.00

MORE GOOD NEWS FOR STRETCH PLANNING WITH NONQUALIFIED ANNUITIES: Private Letter Ruling 2003-13-016 (March 28, 2003)

BACKGROUND: To prevent nonqualified annuities from luxuriating in tax-deferral from one generation to the next, the Code requires distributions after the contract holder's death. §72(s). Qualified plans and traditional IRAs have nearly identical distribution-at-death rules. §401(a)(9). If the owner dies while the contract or account is still in deferral, both sets of rules require that either (1) all amounts be distributed within five years after death; or (2) the payments begin within one year, and not extend beyond the life or life expectancy of the designated beneficiary (presuming the beneficiary is not the surviving spouse).

Qualified plan and IRA beneficiaries have long satisfied these required payments with the life expectancy fraction method (also called the minimum distribution method), distributing an amount equal to the end-of-year account value divided by life expectancy. Only recently have nonqualified contracts granted the same option to beneficiaries, adding an alternative to the traditional annuity stream settlement that was never required by the Code in the first place. The Service privately approved this technique. Priv. Ltr. Rul. 2001-51-038 (September 25, 2001); see *Advanced Planning Briefs* No. 45 (April 12, 2002).

The 2001 private letter ruling did not address whether the beneficiary receives an exclusion ratio if the contract is not settled to an annuity. Also, Treasury shortly afterward issued final qualified plan and IRA regulations that created new life expectancy tables. See *Advanced Planning Briefs* No. 46 (June 14, 2002). Because these regulations are silent as to nonqualified annuities, it has been unclear whether their beneficiaries can use the new tables, which provide slightly longer life expectancies than those found in older nonqualified annuity regulations. *See, e.g.,* Treas. Regs. §1.401(a)(9)-9, Q&A-1, and §1.72-9, Table V.

FACTS: An insurance company amends its nonqualified annuities to give beneficiaries three payment options in addition to traditional annuitization if the owner dies during the deferral period (all payments begin within one year after death):

1. Life expectancy fraction method. This results in smaller payments in the beginning and larger payments toward the end.

2. Fixed amortization method. Similar to amortizing a fixed-rate home mortgage in that it produces equal annual payments calculated to exhaust the account by life expectancy, based on interest and mortality assumptions that are "locked" up front.

3. Annuity factor method. This method is not the same as settling the contract to an annuity stream; the owner instead of the insurer elects an annuity factor. In

addition, because the annuity factor varies annually under this method, it produces unequal payments.

These are the three methods that meet the "substantially equal periodic payments" exception to the 10% penalty for withdrawals before age 59½. See Q&A 12 of Notice 89-25, 1989-1 C.B. 662, and Rev. Rul. 2002-62, 2002-42 I.R.B. 710. For all three methods the insurer uses the life expectancy tables provided by the 2002 final regulations governing qualified plans and IRAs.

Under any of the methods, the beneficiary can irrevocably elect an additional withdrawal option: (a) the right to withdrawal the entire unpaid balance; or (b) the right to take partial or complete withdrawals from the unpaid balance.

ISSUES: The requested rulings, in part, are as follows:

1. That each method meets the §72(s) distribution-at-death requirements, even with the additional accelerated withdrawal option.

2. That each method receives an exclusion ratio as an "amount received as an annuity," so long as the beneficiary irrevocably elects the additional first withdrawal option of having the right to take out the entire balance.

RULINGS: The Service rules favorably on both issues.

REASONING:

1. Each method satisfies the distribution-at-death rules because it starts within one year after death, and does not extend beyond the life or life expectancy of the beneficiary. Furthermore, because they are designed to prevent prolonged deferral, the distribution-at-death rules are satisfied even though the beneficiary can accelerate withdrawals.

2. Each method enjoys an exclusion ratio because the payments satisfy the necessary elements outlined in Treas. Reg. §1.72-2(b)(2).

ANALYSIS: These rulings are good news, some unexpectedly so.

The Service reaffirms its previous pronouncement that the life expectancy fraction method is an acceptable alternative to a traditional annuity settlement when satisfying the distribution-at-death rules. This ruling extends this finding to the amortization and annuity factor method. This is welcome, but not earth shattering. If beneficiaries want to forestall withdrawal as long as possible, they will probably choose the life expectancy fraction method, as it demands the smallest payments in the early years. Currently, Northwestern Mutual's RR Series *Select* variable annuity offers the life expectancy fraction method, but not the amortization or annuity factor methods.

A welcome surprise is the application of the new qualified plan and IRA life expectancy tables to nonqualified contracts. This was hardly a sure thing, as the nonqualified annuity regulations remain unchanged and state that its tables are to be used for "computations under section 72." Treas. Reg. §1.72-9. This means not only longer deferral for beneficiaries, but easier administration for insurers who can use identical tables for IRAs and nonqualified annuities. It is unfortunate that the Service has expressed this generosity, without analysis, in a private ruling; it would be comforting to have this view confirmed in a revenue ruling or notice.

More interesting is the "as an annuity" treatment for those methods that differ from a traditional settlement to an annuity stream. Many practitioners and insurers presumed that these payments would not enjoy an exclusion ratio, and this was the expected trade-off for using one of the different methods. Consider a beneficiary with a 40-year life expectancy. A traditional annuitization of a "life with term certain 20" gives the beneficiary the upside of an exclusion ratio, but if the beneficiary dies after 22 years, the payments cease and there is no money left for the next generation. If that same beneficiary chooses the life expectancy fraction method, a large portion of the account remains at death 22 years later for distribution to the next generation. It was thought that the price paid for this benefit was the lack of an exclusion ratio, with gain-first treatment for the beneficiary's withdrawals. This ruling offers beneficiaries the best of both worlds: exclusion ratio taxation and money remaining after a premature death.

OBSERVATION 1: The Service and the insurer requesting the ruling play it safe. They limit the question of exclusion ratio treatment to the withdrawal option of all-or-nothing, expressly avoiding that issue regarding an option that allows partial withdrawals. There is no inherent reason why exclusion ratio treatment must be denied where partial withdrawals are allowed. In fact some traditional annuity settlements employing an exclusion ratio already offer partial withdrawal rights. How this issue plays out in the future is particularly relevant to beneficiaries of Northwestern Mutual annuities, because our current life expectancy fraction method allows partial withdrawals.

OBSERVATION 2: This Ruling does not change how a "multi-generation stretch" strategy functions. If the beneficiary is the spouse, the distribution-at-death rules allow the annuity to remain in deferral, but the spouse is generally in the same generation as the original owner (except in Hollywood) so no additional deferral is obtained. For nonspouse beneficiaries, the first beneficiary chosen is the one and only life that measures the maximum payout period. See §72(s). If this beneficiary dies earlier than the tables predict, there may be cash to distribute to the next generation, but all distributions must still occur within the initial timetable. Electing a payout method other than traditional annuitization does not extend the original end-point.

OBSERVATION 3: Some believe that beneficiaries necessarily end up with more money if they avoid settling the contract, and "keep it in deferral" under the alternative methods. This is not always true. Even during annuitization the payments of variable contracts can increase due to underlying investment growth (perhaps a naïve or sentimental notion these days), and the beneficiary can change the funds. If a beneficiary

lives to life expectancy, the cumulative amounts received from a non-annuitized contract are not necessarily greater. Although the traditionally-settled contract may have bigger initial distributions, these amounts can be reinvested, and at an assumed interest rate these reinvested amounts along with the growing annuity payments can provide a cumulative payout greater than that provided by the life expectancy fraction method. Beneficiaries should first "run the numbers" using various life span and investment performance assumptions.

IRA DISTRIBUTIONS TO SUB-TRUSTS CAN'T EXCEED OLDEST TRUST BENEFICIARY'S LIFE EXPECTANCY:
Private Letter Rulings 2003-17-041, 2003-17-043 & 2003-17-044 (May 25, 2003)

FACTS: Dad names a trust as beneficiary of his IRA. After Dad's death, Trustee divides the trust into separate sub-trusts for each of Dad's children, ages 31, 19 and 16. The IRA will be divided into separate IRAs and required minimum distributions will be made to each sub-trust from the IRA.

ISSUE: Are the required minimum distributions to each sub-trust based on the life expectancy of that sub-trust's beneficiary?

RULING AND REASONING: No. Distributions from the IRA to all three subtrusts are based on the oldest child's life expectancy.

REASONING: The §401(a)(9) Final Regulations issued on April, 2002 are clear. Separate account treatment is not available to "beneficiaries of a trust with respect to the trust's interest in the employee's benefit." Treas. Reg. §1.401(a)(9)-4, A-5(c). So while a trust can be beneficiary of an IRA, the life expectancy of the oldest trust beneficiary is used in computing required minimum distributions for all trust beneficiaries under §401(a)(9).

Here, a single trust is named as IRA beneficiary. The IRA is divided into three separate IRAs that are distributed to sub-trusts created under the terms of the original trust. Because these distributions "pass through" a trust, separate account treatment is not allowed under the regulations.

ANALYSIS: The Proposed Regulations did not expressly prohibit separate account treatment for sub-trusts created after the participant's death. The Final Regulations, however, expressly preclude the use of separate account rules when one trust is divided into multiple trusts after death. Taking the language of the Final Regulations at face value, these Rulings are technically correct and not a surprise.

In calculating required distributions, why should it make a difference whether the payments flow through a trust or go directly to the individual beneficiary (or separate trusts)? As usual, the I.R.S. is looking to get its money sooner. If the money flows through a trust and is distributed based on the life expectancy of the oldest child, the beneficiaries pay income tax sooner because of larger required distributions.

If the children are close in age, using the life expectancy of the oldest makes little difference. However, if there is a notable difference in ages, the differing life expectancies can have a significant effect on the amount and timing of the tax.

RECOMMENDATIONS: One solution if the intended beneficiaries vary in age is to avoid using a trust. If Dad names "my children" as direct beneficiaries of his IRA, which

is then divided between the children in a timely manner, each child can use his life expectancy when computing required minimum distributions.

Under certain circumstances, a trust may be the only option (*e.g.*, beneficiaries are minors or disabled). If so, a possible solution is to have Dad, during his life, establish a separate trust for each child, with each separate trust named as a direct IRA beneficiary. The IRA assets are not placed into a single trust before distribution to sub-trusts. Instead, the money goes directly to the separate trusts and the separate account rules apply. From a practical standpoint, establishing multiple trusts during life is cumbersome. IRA administrators generally prefer a single trust to be named beneficiary since multiple beneficiaries complicate distributions, and the administrator may reject using multiple trusts as too complex.

I.R.S. ISSUES FINAL REGULATIONS ON 457 PLANS:
Treas. Reg. §§1.457-1 through 1.457-12

BACKGROUND: Last year, the I.R.S. issued proposed regulations under Section 457, which governs deferred compensation for employees of tax-exempt and governmental organizations. For a summary of those proposals, see *Advanced Planning Briefs* No. 51 (January 3, 2003). The proposed regulations primarily addressed "eligible" or "457(b)" plans where the employee can vest immediately in the deferred amount.

Part of the proposed regulations, however, targeted compensatory option arrangements designed to escape the negative tax treatment of "ineligible" or "457(f)" plans. Ineligible plans generally involve larger deferrals and are taxed to the employee when the employee vests in the plan. The argument advanced by promoters of option plans is that the right to buy an asset (*e.g.*, mutual funds) from one's employer is not the deferral of compensation under §457, but is instead taxed under §83.

EXAMPLE: Employee wishes to defer $75,000 until age 65. Under the ineligible plan rules, the benefit must be non-vested (in Code-speak, subject to a "substantial risk of forfeiture") to avoid immediate taxation. The option arrangement instead gives Employee the right to buy 100 shares of xyz mutual fund, currently valued at $100,000. This purchase price, which is locked until retirement, is the greater of $25,000 or 25 percent of the share value. In effect, the Employee achieves the same economic values either way, because the option spread in year one is $75,000. This spread tracks the performance of the mutual funds in the same way as a deferred compensation plan. If the shares double in value, Employee's option spread is $150,000 – identical to doubling of a deferred compensation account balance.

FINAL REGULATIONS: The final regulations incorporate the eligible plan proposals nearly verbatim. A favorable change – excess deferrals into an eligible non-governmental plan do not automatically disqualify the plan as provided in the proposed regulations. The organization can distribute the excess not later than April 15 following the close of the taxable year to correct the problem.

And the option plans? They're dead and buried, much to their promoters' chagrin. The language from the proposed regulations dealing with the integration of Section 457 with Section 83 (which governs non-qualified options) left it unclear whether options were affected. Rather than clean up the language, the Service simply added an example which removes all doubt. In the example above, Employee is taxed in year one when the option is granted on $75,000, unless the option itself is not vested. RIP.

EFFECTIVE DATES: With a few minor exceptions, the regulations apply for taxable years beginning after December 31, 2001. The option provisions apply to options granted after May 8, 2002.

I.R.S. ISSUES PROPOSED REGULATIONS ON STATUTORY STOCK OPTIONS: REG-122917-02 (June 6, 2003)

BACKGROUND: The tax treatment of options to purchase employer stock was initially governed by §83, which generally taxed the spread (exercise price minus grant price) as ordinary income at the time of exercise. Section 422A was enacted in 1981 for plans that qualified as incentive stock option plans under §422 or employee stock purchase plans under §423. Assuming minimum holding requirements are satisfied, these statutory options receive favorable tax treatment by triggering tax only when the stock purchased under the grant is sold, and then at long-term capital gains rates.

PROPOSED REGULATIONS: The new proposed regulations govern incentive stock options and employee stock purchase plans. The proposed regulations are effective 180 days following the issue of final regulations, but employers issuing statutory stock options after June 9, 2003 may rely on the proposed regulations. A public hearing on the proposed regulations will be held on September 2, 2003.

The proposed regulations reorganize the existing rules, while modifying and expanding others, to provide a comprehensive set of regulations. Some provisions include:

Compliance. Statutory option plans and the options themselves must be evidenced in writing, but can be in paper or electronic form if enforceable under applicable law.

Stockholder approval. Additional guidance is given on determining when stockholder approval is required.

Issuers. More entities are able to issue incentive stock options. The proposed regulations allow not only C corporations, but also S corporations, foreign corporations, and limited liability companies taxed as corporations to issue incentive stock options.

Cashless exercise. The opportunity to exercise an option by using existing shares may be offered to employees without disqualifying the plan. If, however, the surrendered shares were previously acquired under a statutory option plan and the holding period from the prior exercise has not expired, the employee recognizes income attributable to the prior exercise.

Disqualifying dispositions. Under the old regulations, statutory options transferred for a reason other than death were disqualified. The proposed regulations allow for the transfer to a trust in which the employee is the sole beneficial owner.

The proposals also clarify that transfers of an option to an ex-spouse pursuant to divorce disqualifies the options. If the options have been exercised by the employee, a transfer of the acquired stock to the ex-spouse does not cause disqualification even if the option holding period has not expired.

If a disqualifying disposition occurs, the difference between fair market value on the date of transfer and exercise price is compensation income in the year the disqualifying transfer occurs, as though the options were nonstatutory. Special rules for loss situations are also provided.

$100,000 limitation. Up to $100,000 of options exercisable in a given year may be treated as incentive stock options, using the fair market value at grant to calculate value. I.R.S. Notice 87-49, 1987 C.B. 355. The proposed regulations provide rules for determining whether options fall within the $100,000 limitation, and treatment of those exceeding the limit.

OBSERVATIONS: With the Jobs and Growth Tax Relief Reconciliation Act of 2003, signed on May 28, 2003, the top long-term capital gains rates drop to 15% from 20% for the years 2003-2008. This reduction benefits some statutory option holders who satisfy the minimum holding requirements to receive long-term capital gain treatment on the spread between sale price at disposition of the stock and the option's exercise price. For qualifying dispositions in 2009-2010, the rate is 18% under pre-JGTRRA law if the combined holding period for the option and stock exceeds 5 years. §1(h). Otherwise, a qualifying transaction for these years is taxed at 20%.

The proposals allow statutory options to be transferred during life to a trust if the "individual" (presumably the employee) owns the option under state law and for federal income tax purposes under §671 "while the option is held in the trust." This language appears to sanction lifetime transfers to most revocable trusts, but raises unanswered questions concerning irrevocable trusts. Even though an irrevocable trust may be "owned" by an individual for federal income tax purposes, it might not be under state law. Further, the regulations do not indicate which area of state law governs – is it trust law, property law, or tax law?

Following the employee's death he is no longer the owner for income tax purposes of either a revocable or irrevocable trust. This raises additional questions if the options remain unexercised at that time. Are they still qualified? Were they ever qualified? Until these unresolved issues are fleshed out, the transfer of statutory options to a trust during the employee's life presents some risk.