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TAX ISSUES SUMMARY

December 28, 2004

HIGHLIGHT:

I.R.C. § 409A — Transition Guidance on Non-Qualified Deferred Compensation Issued

On December 20th, the IRS issued transitional guidance on the treatment of non-qualified deferred compensation plans under I.R.C. § 409A. Notice 2005-1, 2005-2 I.R.B. ____ I.R.C. § 409A, enacted by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, provides that all amounts deferred under a non-qualified deferred compensation plan are currently includible in gross income to the extent they are not subject to a substantial risk of forfeiture and not previously included in gross income. Generally, the Notice provides guidance on what is subject to the new rules as deferred compensation and outlines the new reporting and employment tax obligations of employers in connection with I.R.C. § 409A. The Notice also provides transitional relief for existing plans that undergo a material modification. I.R.C. § 409A applies to deferrals that occur after December 31, 2004, and deferrals in existing plans that have been materially modified after October 3, 2004.

LEGISLATION

In General

Apart from a technical correction to the bows and arrows excise tax provision in the American Jobs Creation Act of 2004, which was passed by both houses of Congress and signed by President Bush when they returned briefly after Thanksgiving to pass an omnibus appropriations bill, the legislative tax front has been quiet in the month of December. Although there have been discussions with and among members of the Administration about tax reform being on the agenda for 2005, most Washington watchers think that social security reform will take precedence, pushing tax reform to 2006 at the earliest. What the Administration might set for its agenda is expected to be highlighted by President Bush in his inaugural address, with details to follow in the Administration's budget.

POLICYHOLDER ISSUES

1. I.R.C. §§ 111 and 419 — Using Post-Retirement Life Reserves to Fund Post-Retirement Health Benefits Will Not Result in Income

In PLR 200449036 (Sept. 8, 2004), the IRS determined that a proposed amendment to a corporation's voluntary employees' beneficiary associations ("VEBAs"), allowing the use of assets held in post-retirement life insurance reserves to pay for post-retirement health benefits, would not trigger the tax benefit rule or result in income to the corporation. In the facts of the ruling, a corporation maintained four trusts that provided post-retirement life insurance and health benefits which qualified as VEBAs under I.R.C. § 501(c)(9). The VEBAs held assets that were attributable to assets held in post-retirement life insurance reserves and attributable to deductions taken prior to the enactment of I.R.C. § 419 by the Deficit Reduction Act of 1984 (Pub. L. No. 98-369) ("DEFRA"). The corporation proposed to amend two of the VEBAs, and certain group term life insurance policies they held, allowing the corporation to use the pre-DEFRA life reserve amounts to pay post-retirement benefit costs. Additionally, a provision would permit pre-DEFRA reserve amounts not used to pay benefits to be released from the retired lives reserve and deposited in a separate post-retirement health benefit account within the trust. The amount deposited in a separate account would not exceed what would otherwise be currently deductible under I.R.C. § 419(a)(2) as a contribution to fund post-retirement health benefits.

The IRS commented that the deductibility of contributions to a welfare benefit fund before the enactment of I.R.C. § 419 would have been determined under I.R.C. § 162. Under the tax benefit rule, the original amounts would have been fully deductible if made to fund either post-retirement life insurance or health reserves. The IRS concluded that the use of amounts originally contributed to fund post-retirement life insurance to instead fund post-retirement health benefits would not be fundamentally inconsistent with the deductions taken in the previous years, and therefore the inclusionary part of the tax benefit rule would not require the corporation to recognize the assets as income. Additionally, the IRS found that the proposed VEBA amendments would not result in the provision of any "disqualified benefits" and, therefore, would not impose any tax liability on the corporation under I.R.C. § 4976.

2. I.R.C. §§ 419 and 419A — California District Court Denies a Preliminary Injunction Against Promoter

On December 3rd, the United States District Court for the Southern District of California issued an order discontinuing a preliminary injunction against several alleged xélan promoters of tax-advantaged transactions. United States v. Guess, No. 04 CV 2184-LAB(AJB) (S.D. Cal. Dec. 15, 2004). Previously, the court had frozen over \$500 million in assets belonging to xélan and related entities, alleged promoters of tax advantaged transactions – including 10-or-more employer plans under I.R.C. § 419A(f)(6) – and instructed several individuals to surrender their passports. Upon reconsideration, the court determined that the IRS did not demonstrate that it clearly could succeed in its prosecution of xélan and, therefore, a preliminary injunction was not warranted. While not ruling on the viability of xélan's plans, the court determined that the IRS did not possess enough information to determine whether the tax laws were violated. This is the second recent win for xélan, following an order in a third-party summons action involving a taxpayer-purchaser of xélan's section 419 plans in the United States District Court for the Southern District of Iowa. xélan, Inc. v. United States, No. M-03-83 (S.D. Iowa Nov. 18, 2004). The court determined that the government did not produce enough evidence to conclude that the IRS is

entitled to the identities of all participants in xélan's section 419 plans and ordered the IRS to provide further arguments as to why it is entitled to the identities. However, it is expected that the IRS ultimately will be entitled to this information, as the same Magistrate Judge submitted a report and recommendation permitting the IRS access to the names of xélan's policyholders and insureds in xélan v. United States, No. M-04-83 (S.D. Iowa Dec. 23, 2004), a third-party summons action related to the examination of xélan as a potential tax shelter promoter.

COMPANY ISSUES

1. I.R.C. §§ 263 and 446 — IRS Updates Procedure for Automatic Consent to Change Accounting Method for Capitalizing Intangibles

The IRS, in Rev. Proc. 2005-9, 2005-2 I.R.B. ____, issued guidance detailing the procedure for a taxpayer to obtain automatic consent for a change in accounting method for capitalizing intangibles during its second taxable year ending on or after December 31, 2003. The revenue procedure expands on Rev. Proc. 2004-23, 2004-16 I.R.B. 785, which provided similar instructions for obtaining automatic consent for a change in accounting method for a taxpayer's first year ending on or after December 31, 2003. However, Rev. Proc. 2005-9 requires taxpayers to complete sections of Form 3115, Application for Change in Accounting Method, not required by Rev. Proc. 2004-23. The new revenue procedure also provides for taxpayer relief, allowing taxpayers to review and make corrections to filed returns, and includes provisions related to the computation of the I.R.C. § 481(a) adjustment, reported on Form 3115.

2. I.R.C. § 409A — Transition Guidance on Non-Qualified Deferred Compensation Issued

In a question-and-answer format, the IRS issued transitional guidance on the treatment of non-qualified deferred compensation plans under I.R.C. § 409A. Notice 2005-1, 2005-2 I.R.B. ____. I.R.C. § 409A, enacted by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, provides that all amounts deferred under a non-qualified deferred compensation plan are currently includible in gross income to the extent they are not subject to a substantial risk of forfeiture and not previously included in gross income. Generally, the Notice provides guidance on what will be considered deferred compensation subject to the new rules and outlines the new reporting and employment tax obligations of employers in connection with I.R.C. § 409A. The Notice defines non-qualified deferred compensation as amounts received from a plan under which a service provider has a legally binding right to compensation that has not been received, actually or constructively, and included in gross income and, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year. This legally binding right does not exist if the compensation may be unilaterally reduced or eliminated by the service recipient or other party after the service provider performs the services creating the right to compensation. The Notice also provides transition relief for existing plans that undergo a material modification after October 3, 2004. For example, employers are allowed to convert plans providing employees with stock appreciation rights (which would have been subject to I.R.C. § 409A) to plans providing stock options (not covered by I.R.C. § 409A) without the plan amendment doing so being treated as a material modification. I.R.C. § 409A applies to deferrals that occur after December 31, 2004, and deferrals in existing plans that have been materially modified after October 3, 2004.

3. I.R.C. §§ 6222 and 6694 — Guidance on Accuracy-Related Penalty Updated

In Rev. Proc. 2004-73, 2004-51 I.R.B. 999, the IRS updated previous guidance regarding the adequacy of the tax return disclosure of items for the purpose of reducing the understatement of tax under I.R.C. § 6662(d) and the preparer penalty under I.R.C. § 6694(a). In Rev. Proc. 2003-77, 2003-2 C.B. 964, and Rev. Proc. 2002-66, 2002-2 C.B. 724, the IRS identified circumstances under which disclosure on a taxpayer's return with respect to an item or position is adequate under I.R.C. §§ 6662(d) and 6694(a). Rev. Proc. 2004-73 clarifies that taxpayers must provide a description of the item, if it is not pre-printed, and provides procedures for reporting the book/tax difference on Schedules M-1 and M-3. The IRS requests comments on whether adjustments to arrive at line 11, Part I of Schedule M-3, will provide adequate disclosure and whether taxpayers should be required to apprise the IRS of the nature of the potential controversy. Rev. Proc. 2004-73 applies to returns for taxable years beginning in 2004 and returns filed on 2004 forms for short taxable years beginning in 2005.

4. IRS Releases Final Instructions for Schedule M-3

On December 2nd, the IRS released final instructions for Schedule M-3 of Form 1120, Net Income (Loss) Reconciliation for Corporations With Assets of \$10 Million or More, providing more specific information than was included in the original draft. While providing no substantial changes to earlier draft instructions and guidance, the "Who Must File" section has been dramatically lengthened. The guidelines for insurers are the same to those provided in News Release IR-2004-91 (July 7, 2004), providing that no member of a consolidated group filing Form 1120-L or 1120-PC will be required to file the Schedule M-3, regardless of whether any members of the group file a Form 1120. By contrast, if a group filing on Form 1120 includes members for which Form 1120-L or 1120-PC is prepared, Schedule M-3 must be completed. However, the members that file Form 1120-L or 1120-PC have the option of completing the Schedule M-3 in its entirety or reporting book/tax differences on an aggregate basis on line 26 of Part II of the Schedule with a supporting schedule that separately states and discloses each difference on an item-by-item basis. The filing of Schedule M-3 will be required for tax years beginning on or after December 31, 2004. The IRS is expected to release Schedule M-3 before year-end.

5. Final Regulations on Circular 230 Issued

Final regulations (T.D. 9165) on Circular 230, governing the practice before the IRS, were issued on December 17th, providing best practices and standards for written advice by tax advisors providing advice related to federal tax issues. The preamble to the regulations states that best practices are "aspirational" and practitioner non-compliance with these standards will not be subject to discipline under these regulations. The regulations apply to written opinions on federal tax issues arising from: (1) a listed transaction; (2) a plan or arrangement with the principal purpose of tax avoidance or evasion; or (3) a plan or arrangement with a significant purpose of tax avoidance or evasion, if the advice is a reliance or marketed opinion or is subject to conditions of confidentiality or contractual protection. The regulations detail the requirements for covered opinions, disclosures and other written advice. Specifically, opinions must contain prominent disclosures regarding the scope and reliability of the opinions.

6. IRS Releases Draft Form 1120-L for Comment

An advance proof copy of the 2004 draft Form 1120-L, U.S. Life Insurance Company Income Tax Return, has been made available at <http://www.irs.gov/pub/irs-dft/d1120l.pdf>. Comments on the form may be submitted before January 9, 2005 through the IRS's website.

7. 2004-2005 Priority Guidance Plan Is Revised

On December 21st, the IRS issued a revised priority guidance plan for 2004-2005. Under the heading "Insurance Companies and Products," the following items are listed for future action: (a) final regulations under I.R.C. § 817 on life insurance and annuity contracts; (b) guidance on the application of the diversification look-through rule under I.R.C. § 817 to tiered investment companies; (c) a revenue ruling on qualified additional benefits under I.R.C. § 7702 (which was recently added); and (d) guidance regarding captive insurance companies (also, newly added).

For comments or questions, or if you would like to receive the Tax Issues Summary via electronic mail, please contact Joseph A. Sergi at (202) 434-9172 or jsergi@scribnerhall.com Scribner, Hall & Thompson, LLP, website: www.scribnerhall.com