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TAX ISSUES SUMMARY

April 28, 2005

***HIGHLIGHTS*:**

I.R.C. §§ 79, 83 and 402 — IRS Releases New Valuation Safe Harbors

In Rev. Proc. 2005-25, 2005-17 I.R.B. 962, the IRS modified guidance on determining the fair market value of certain life insurance contracts, providing additional safe harbors for both non-variable and variable contracts. Valuation under either of the safe harbors will meet the definitions of fair market value for purposes of I.R.C. §§ 79, 83, 402(a) and 402(b) and vested accrued benefit for purposes of I.R.C. § 402(b)(4)(A). Additionally, the revenue procedure provides guidance on amounts that must be included in income, including the treatment of dividends held on deposit and the treatment of loans. See Policyholder Issues.

LEGISLATION

1. In General

Both the House and Senate hope to have a 2006 Joint Budget Resolution by the end of April. However, despite House and Senate budget conferees meeting and seeming to arrive at a compromise, passage of that compromise in either house of Congress is not a sure thing because of opposition to proposed cuts in Medicaid. The budget compromise is expected to provide for $70 billion in reconciliation for tax cuts, and most of that is expected to be used to extend or make permanent prior tax cuts. In turning to the budget, both houses temporarily set aside work on the highway bill.

2. Bill Introduced to Clarify Tax Treatment of 10-or-More Employer Health Plans

On April 25th, Senator Hatch (R-Utah) introduced a bill (S. 897) to clarify the tax treatment of 10-or-more employer health plans sponsored by associations. In light of recent regulations tightening the experience-rating requirements for those plans, the bill would provide that medical benefit plans of bona fide associations may reserve up to 35 percent, which is an amount designed to give association health plans the flexibility they need without raising the potential for abuse. Both Senate Finance Chairman Grassley and ranking Democrat Senator Baucus are co-sponsors of the bill.

3. Congress Passes New Bankruptcy Act

On April 20th, President Bush signed into law The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, which amends the current Bankruptcy Code by making it more difficult for debtors to shed financial obligations in court. Among the provisions in the Act are: a requirement that tax returns be filed with bankruptcy petitions; mandatory credit counseling for debtors; a limitation on the homestead exemption available to debtors; an increase in bankruptcy filing fees; and a streamlined process for small businesses that file for Chapter 11 bankruptcy reorganization. The Act also excludes from the definition of estate property contributions to ERISA-qualified retirement plans, deferred compensation plans, tax-deferred annuities and health insurance plans. The Act generally is effective October 20, 2005 (180 days from enactment), although some provisions take effect immediately.

POLICYHOLDER ISSUES

1. I.R.C. § 61 — Transaction Transferring Life Insurance Policies Between Grantor Trusts Disregarded for Tax Purposes

In identical rulings, PLR 200514001 (Dec. 13, 2004) and PLR 200514002 (Dec. 13, 2004), the IRS concluded a transaction transferring life insurance policies between two grantor trusts, owned by the same individual, should be disregarded for purposes of federal income tax. In the facts of each ruling, an individual has created two trusts: a grantor trust with assets including two split-dollar whole life insurance policies and a grantor trust with significant net worth, including shares of the individual's employer's stock. The individual taxpayer proposed to transfer the life insurance policies from the first trust to the second trust in exchange for non-stock consideration. The IRS indicated that Rev. Rul. 85-13, 1985-1 C.B. 184, provides that a transaction is disregarded for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction. Because the individual taxpayer is considered the owner of both grantor trusts, he should be the treated as owning the purported consideration for the transfer of the policies both before and after the transaction. The transaction, therefore, should be disregarded for federal income tax purposes and should not be considered, under I.R.C. § 101(a)(2), a transfer for a valuable consideration.

2. I.R.C. §§ 72, 408 and 522 — Supreme Court Holds IRAs Exempt from Bankruptcy Estates

The Supreme Court, in Rousey v. Jacoway, 125 S.Ct. 1561 (Apr. 4, 2005), determined that Individual Retirement Accounts ("IRAs") may be exempted from the reach of creditors in bankruptcy to the extent the IRA funds are necessary for support. In the facts of the case, married debtors each received lump-sum distributions from their pension plans upon termination of their employment and deposited those sums into IRAs through nontaxable rollovers. The couple subsequently filed for joint Chapter 7 bankruptcy and claimed such portions of their IRAs were shielded from creditors under 11 U.S.C. § 522(d)(10)(E), which provides an exemption for the right to receive "a payment under a stock bonus, pension, profit-sharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor." In agreeing with the debtors' classification, the Court found that IRAs are similar plans with payments made "on account of age" because of two significant age-related penalties applicable to IRAs: the penalty for taking funds out of the plan before age 59½ and the annual penalty for not taking enough money out of the plan after age 70½. The Court also determined that the treatment of IRAs under the Internal Revenue Code demonstrates that IRAs are considered substitutes for wages. Thus, the Court concluded that the IRAs meet the requirements of 11 U.S.C. § 522(d)(10)(E) and are exempt from the bankruptcy estate if needed for support. However, with passage of The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (see Legislation, above), debtors are able to exclude all IRA funds without the necessity of proving that they needed the funds for support. Therefore, the precedential value of this case is limited.

3. I.R.C. §§ 79, 83 and 402 — IRS Releases New Valuation Safe Harbors

In Rev. Proc. 2005-25, 2005-17 I.R.B. 962, the IRS modified guidance on determining the fair market value of certain life insurance contracts, providing additional safe harbors for both non-variable and variable contracts. In response to comments, the IRS modified earlier guidance provided in Rev. Proc. 2004-16, 2004-10 I.R.B. 559, and proposed regulations (REG-126967-03). Valuation under either of the safe harbors will meet the definitions of fair market value for purposes of I.R.C. §§ 79, 83, 402(a) and 402(b) and vested accrued benefit for purposes of I.R.C. § 402(b)(4)(A). Additionally, the revenue procedure provides guidance on amounts that must be included in income, including the treatment of dividends held on deposit and the treatment of loans. Rev. Proc. 2005-25 generally applies to transactions occurring on or after February 13, 2004. Taxpayers may rely on the safe harbors provided in Rev. Proc. 2005-25 for periods before May 1, 2005 and may rely on either Rev. Proc. 2005-25 or Rev. Proc. 2004-16 for periods on or after February 13, 2004, and before May 1, 2005.

4. I.R.C. § 419 — IRS Rules VEBA Holding Assets for Welfare Benefit Fund Is Considered a Welfare Benefit Fund

In TAM 200514022 (Dec. 16, 2004), the IRS determined that a voluntary employees' beneficiary association ("VEBA") that holds assets for employee welfare benefit plans constitutes a welfare benefit fund under I.R.C. § 419. In the facts of the TAM, a trust was established by an employer, along with several trustees, to implement and form a VEBA. Benefit payments provided by the VEBA were made through the trust, which either directly paid health care providers or employees using I.R.C. § 125

flexible spending accounts ("FSAs"). Other than the FSA benefits funded by employee contributions, the employer funded all benefits through the trust. The operation of the trust was then changed so that the employer only contributed to the trust at year end, in an amount estimated to be equal to the amount of claims incurred but unreported at year end. All benefits provided by the VEBA, other than those associated with the employees' FSAs, were paid directly by the employer, and the trust reimbursed the employer and accepted, as a liability, the debts and expenses related to the payment of medical expenses incurred by the employer.

The IRS examined the definition of qualified direct costs, under I.R.C. § 419(c)(3), to determine whether amounts paid with respect to benefits provided during the taxable year are deductible only to the extent they are provided by the welfare benefit fund (including those provided by the employer as an agent of the fund) or if benefits provided by both the fund and the employer are deductible. The IRS concluded that payments of benefits made directly by the employer and not reimbursed by the trust are not deductible as qualified direct costs. Additionally, reimbursement payments received by the employer may not be includible as qualified direct costs if those payments are viewed as depleting the qualified asset account additions deducted in the prior year. Finally, under I.R.C. § 419A(c), the limit on a qualified asset account that is the subject of an actuarial certification is the amount reasonably and actuarially necessary to fund claims incurred but not paid. The IRS determined that an actuarial certification may be based on the total expenditures of the welfare benefit fund, plus expenditures of the sponsoring employer that would be considered qualified direct costs if paid by the welfare benefit fund, to the extent the expenditures are for claims paid in years subsequent to the years in which the claims were incurred.

5. I.R.C. § 7872 — IRS Releases Audit Guide on Split-Dollar Life Insurance

The IRS released a Market Segment Specialization Program audit guide containing examination techniques for split-dollar life insurance arrangements. The guide makes recommendations to agents regarding the type of information that should be requested when examining split-dollar insurance arrangements. Among the items suggested for review are SEC filings, corporate minutes, employer contracts, insurance policies and the insurer's website.

COMPANY ISSUE

I.R.C. §§ 6011, 6112, 6501 and 6707 — IRS Provides Guidance on Undisclosed Listed Transaction Exception to Three-Year Assessment Period

Rev. Proc. 2005-26, 2005-17 I.R.B. 965, provides guidance related to I.R.C. § 6501(c)(10), which was enacted as part of the Jobs Act and allows for an extended period of limitations to assess any tax with respect to a listed transaction that a taxpayer failed to disclose under I.R.C. § 6011. I.R.C. § 6501 generally provides that, absent fraud or substantial omission, taxes must be assessed within three years after the date the return is filed. I.R.C. § 6501(c)(10) extends the statute of limitations for listed transactions if the taxpayer fails to disclose the transaction as required by I.R.C. § 6011. The new extended statute of limitations expires one year after the earlier of the date on which the Treasury Secretary is furnished the required information or the date the material advisor meets the list maintenance

requirements of I.R.C. § 6112 relating to the transaction with respect to the taxpayer. Rev. Proc. 2005-26 sets forth procedures that taxpayers and material advisors may follow to disclose previously undisclosed listed transactions for purposes of I.R.C. § 6501(c)(10) and guidance on the date that the period of limitations will expire if the procedures are not followed. The revenue procedure is effective April 8, 2005. The IRS has requested comments concerning the procedures by June 7, 2005.

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
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