

# SCRIBNER, HALL & THOMPSON, LLP

THOMAS C. THOMPSON, JR.  
MARK H. KOVEY  
STEPHEN P. DICKE  
PETER H. WINSLOW  
SUSAN J. HOTINE  
BIRUTA P. KELLY  
GREGORY K. OYLER  
LORI J. BROWN  
SAMUEL A. MITCHELL  
LYNLEE C. BAKER-GARBETT

SUITE 1050  
1875 EYE STREET, N. W.  
WASHINGTON, D. C. 20006-5409  

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(202) 331-8585  
FAX (202) 331-2032

FRED C. SCRIBNER, JR. (1908-1994)  
LEONARD W. HALL (1900-1979)

Writer's Direct Dial: 202-741-9172

Writer's Email Address:

[Lbaker@scribnerhall.com](mailto:Lbaker@scribnerhall.com)

## Insurance Company Information Reporting and Withholding Update

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## I. Legislation

### A. Pension Protection Act of 2006 Targets Executive Compensation Abuses/COLI

The Pension Protection Act of 2006 (P.L. No. 109-280) (the “Pension Act”) was signed into law on August 17, 2006, and includes provisions targeting certain executive compensation abuses and COLI. Section 116 of the Pension Act amended I.R.C. § 409A to restrict funding of nonqualified deferred compensation trusts and other arrangements by employers that maintain “at risk” single employer defined benefit pension plans. Section 863 of the Pension Act generally requires businesses to treat proceeds from company owned life insurance contracts (“COLI”) as income with the policyholder excluding as a death benefit only the premiums and other amounts it paid for the contracts. See I.R.C. § 101(j). Contracts are excepted from this rule, however, where notice and consent requirements are satisfied, and:

- (1) the insured was an *employee at any time during the 12-month period before the insured's death*, or is, at the time the contract is issued – a *director*, a *highly compensated employee* within the meaning of section 414(q) (without regard to paragraph (1)(B)(ii) thereof), or a *highly compensated individual* within the meaning of section 105(h)(5), except that "35 percent" shall be substituted for "25 percent" in subparagraph (C) thereof; or
- (2) the benefits are paid to the family of the insured, a trust established for the benefit of a family member, or used to purchase an equity interest in the applicable policyholder.

The notice and consent requirements are met if, before issuance of the contract, the employee –

- (i) is notified in writing that the applicable policyholder intends to insure the employee’s life and the maximum face amount for which the employee could be insured at the time the contract was issued;
- (ii) provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment; and
- (iii) is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.

Generally, except for contracts issued under a I.R.C. exchange (dealing with the tax-free exchange of insurance policies and annuities), the COLI inclusion rules apply to contracts issued after Aug. 17, 2006.

### *Reporting and Recordkeeping Requirements*

Policyholders that own one or more employer-owned life insurance contracts issued after the date of enactment must satisfy annual reporting and recordkeeping requirements. Under I.R.C. § 6039I(a), such policyholders must file a return (at such time and in such manner as the Secretary shall prescribe by regulations) showing:

- (1) the number of employees of the applicable policyholder at the end of the year;
- (2) the number of such employees insured under such contracts at the end of the year;
- (3) the total amount of insurance in force at the end of the year under such contracts;
- (4) the name, address, and taxpayer identification number of the applicable policyholder and the type of business in which the policyholder is engaged; and
- (5) that the applicable policyholder has a valid consent for each insured employee (or, if all such consents are not obtained, the number of insured employees for whom such consent was not obtained).

Under I.R.C. § 6039I(b), each applicable policyholder owning one or more employer-owned life insurance contracts during the year must keep such records as may be necessary for purposes of determining whether the requirements of this section and section 101(j) are met.

## II. Form 1099, Backup Withholding, and Penalties

### A. Employment Taxes and Penalties Owed In Case of Sham Trust

In Lundgren v. Commissioner, T.C. Memo. 2006-177, the Tax Court disregarded the existence of a trust as separate from the taxpayers, and held that the taxpayers were liable for self-employment tax on trust income and capital gains tax. In this case, the taxpayers argued that they were mere tenant farmers and caretakers of land owned by the trust, and not owners of or in control of trust assets or income. The court disregarded the trust as a sham, and attributed income to the taxpayers. The court also imposed accuracy-related and frivolous claim penalties under I.R.C. §§ 6662 and 6673(a)(1).

### B. Tax Court Finds Former IRS Attorney Liable for Self-employment Tax, Penalty

In Michael Allen Byer v. Commissioner, T.C. Summ. Op. 2006-125, the Tax Court ruled that the taxpayer, a former IRS auditor and tax attorney with a masters of law in taxation, was liable for self-employment tax because he was not a statutory employee as a full-time insurance salesman, for purposes of I.R.C. § 3121(d)(3)(B) and Treas. Reg. § 31.3121(d)-1(d)(3)(ii). The court notes that the taxpayer was paid \$5,000 per month and was controlled to some extent in that his participation was required in seminars and marketing promotions, but these factors were not overriding. The court also sustained the IRS's determination of income and deductible

expenses, and imposed the I.R.C. § 6662(a) accuracy-related penalty. The court states that based on the taxpayer's education, knowledge, and experience, it had "no choice but to sustain respondent" on the penalty issue. See Byer at 125.

### III. Life Insurance, Annuities, and Qualified Plans

#### A. No 1035 Exchange Where Reinvest Proceeds from Nonqualified Annuity

In PLR 200622020 (June 2, 2006), the IRS ruled that the taxpayer cannot rollover or exchange the proceeds from a nonqualified annuity contract for another annuity contract tax-free. Proceeds from certain qualified annuity contracts can be rolled over into another annuity contract under I.R.C. §§ 402(c)(4), 403(a)(4), 403(b)(8), 408(d)(3)(A), and Treas. Reg. § 1.402(c)-2. However, similar provisions do not exist for the rollover of proceeds from nonqualified annuity contracts. Nor can the transfer qualify under the nonrecognition provisions of I.R.C. § 1035 because those provisions contemplate a contract for contract exchange. As a result, the proceeds are generally includable in the taxpayer's gross income to the extent allocable to income on the contract under I.R.C. § 72.

#### B. Distribution Upon Decedent's Death Loses Character after Rollover

In Gee v. Commissioner, 127 T.C. 1 (2006), the Tax Court ruled that the ten-percent penalty tax under I.R.C. § 72(t) applied to an early distribution from the taxpayer's IRA account irrespective of whether some amounts in the account originated from distributions made to her as a beneficiary from her deceased husband's IRA, i.e., were amounts exempt from the ten-percent penalty tax under I.R.C. § 72(t)(2)(A)(ii). The court concluded that once the taxpayer rolled over the funds from her husband's IRA, the source of the funds became irrelevant. The court reasoned that once the funds were rolled over, the taxpayer became the owner of the IRA "for all purposes of the Code," citing Treas. Reg. § 1.408-8, Q&A-5 and 7. The distribution the taxpayer received was not occasioned by the death of her husband nor made to her in her capacity as beneficiary. Accordingly, the distribution from the taxpayer's IRA was subject to the ten-percent penalty tax. However, the court declined to impose the substantial understatement penalty under I.R.C. § 6662(a). The court determined that the taxpayer acted reasonably and in good faith because she made a reasonable attempt to comply with the tax code with respect to an issue of first impression.

#### C. Employers Advised to Meet Section 409A Compliance Deadlines

Though there have been calls for postponement of compliance deadlines under I.R.C. § 409A, speakers at a recent seminar advised employers to attempt to meet the December 31, 2006 (for documentary compliance) and January 31, 2007 (for employer reporting and withholding obligations) deadlines. Proposed regulations imposing the deadlines were issued

September 29, 2005 after I.R.C. § 409A was added to the Code under the American Jobs Creation Act of 2004 (Pub. L. No. 108-357). The IRS has not published guidance on how to determine the amount that should be reported for nontaxable amounts. It remains unclear whether employers must withhold the 20 percent excise tax penalty and interest owned on amounts that fall under I.R.C. § 409A. At a June 5 meeting of the American Institute of Public Accountants' National Conference, Daniel Hogans, attorney-adviser in the Office of Tax Policy, said that officials are considering what will be an appropriate schedule for implementation.

#### IV. Employer Issues and Employee Benefits

##### A. Medical Reimbursements That Can be Paid to Beneficiary Includible in Income

In Rev. Rul. 2006-36, 2005-16 I.R.B. (amplifying Rev. Rul. 2002-41, 2002- 2 C.B. 75, and Notice 2002-45, 2002-2 C.B. 93), the IRS ruled that amounts paid to an employee under a reimbursement plan are not excludable from the employee's gross income under I.R.C. § 105(b) if the plan permits amounts to be paid as I.R.C. § 213(d) medical benefits to a designated beneficiary other than the employee's spouse or dependents. Under the facts of the ruling, the reimbursement plan provides that upon the death of the deceased employee's surviving spouse and last dependent, or upon the death of the employee if there is no surviving spouse or dependents, any unused reimbursement amount is paid as reimbursement of substantiated medical care expenses of a beneficiary designated by the employee.

Generally, coverage and reimbursements of medical care expenses of an employee and the employee's spouse and dependents, under an employer-provided accident or health plan, are excludable from the employee's gross income under I.R.C. § 106 (relating to contributions by employer to accident and health plans), and I.R.C. § 105 (relating to amounts received under accident and health plans). Under Treas. Reg. § 1.105-2, only amounts paid specifically to reimburse the taxpayer for *expenses incurred by the taxpayer, spouse or dependents* for the prescribed medical care are excludable from gross income. In addition, Rev. Rul. 2005-24 provides that an amount (including an amount paid to reimburse medical expenses) paid from a plan that provides for the payment of the unused reimbursement amount in cash or other benefits is not excludable from the employee's gross income under I.R.C. §105(b). Applying these principles to amounts paid for reimbursement of medical expenses to designated beneficiaries other than the employee's spouse or dependents, the IRS concludes that none of the payments made from the reimbursement plan during the plan year to any person, including amounts paid to reimburse the medical expenses of an employee or the employee's spouse or dependents, is excludable from the gross income.

##### B. New Regulations Provide Guidance for Income Tax Withholding on Supplemental Wage Payments

In T.D. 9276, Treasury and the IRS issued final regulations concerning withholding on

supplemental wages. The regulations include guidance on mandatory income tax withholding on supplemental wages in excess in \$1,000,000 during the calendar year as provided by the American Jobs Creation Act of 2004 (Pub. L. No. 108-357) (the "AJCA"). According to the preamble, the final regulations reflect an effort to achieve the goal of approximating the income tax liability of the employee receiving the wages without placing undue administrative burdens on employers.

Definitions of Regular Wages and Supplemental Wages: The final regulations have adopted the definitions of regular wages and supplemental wages provided in the proposed regulations with certain modifications. The final regulations, like the proposed regulations, provide that supplemental wages include any wages paid by an employer that are not regular wages. See Treas. Reg. § 31.3402(g)-1(a)(1)(i). However, in response to comments, the final regulations eliminate the rule that a payment can qualify as supplemental wages only if regular wages have been paid to the employee. Under the final regulations, payments that satisfy the basic definition of supplemental wages (i.e., all wage payments other than regular wage payments) will be supplemental wages regardless of whether the employee has received any regular wages in his or her working career with the employer. In response to comments, the final regulations permit employers to treat tips and/or overtime pay as regular wages. See Treas. Reg. § 31.3402(g)-1(a)(1)(v). To provide employers with more flexibility, any such treatment is not required to be applied uniformly to all employees of the employer. However, the final regulations do not allow an employer to treat commissions, third party sick pay paid by agents of the employer, or taxable fringe benefits as anything other than supplemental wages.

Procedures for Withholding on Supplemental Wages of \$1,000,000 or Less: The final regulations continue to provide that, if an employee has not received cumulatively more than \$1,000,000 of supplemental wages during the calendar year, generally there are two procedures available to an employer in withholding on a payment of supplemental wages:

(1) Aggregate Procedure – employers calculate the amount of withholding due by aggregating the amount of supplemental wages with the regular wages paid for the current payroll period or for the most recent payroll period of the year of the payment, and treating the aggregate as if it were a single wage payment for the regular payroll period. See Treas. Reg. § 31.3402(g)-1(a)(6).

(2) Optional Flat Rate Withholding. Optional flat rate withholding on supplemental wages (of \$1,000,000 or less cumulatively) allows employers to disregard the amount of regular wages paid to an employee as well as the withholding allowances claimed by an employee on Form W-4, "Employee's Withholding Allowance Certificate," and use a flat percentage rate specified in the regulations in calculating the amount of withholding. See Treas. Reg. § 31.3402(g)-1(a)(7). However, optional flat rate withholding on supplemental wages is generally available only if (1) the employer has withheld income

tax from regular wages paid the employee, and (2) the supplemental wages are either (a) not paid concurrently with regular wages or (b) separately stated on the payroll records of the employer.

Procedures for Withholding on Supplemental Wages in Excess of \$1,000,000:

In accordance with the AJCA, the final regulations provide that if the sum of a supplemental wage payment and all other supplemental wage payments paid by an employer to an employee during the calendar year exceeds \$1,000,000, the withholding rate on the supplemental wages in excess of \$1,000,000 shall be equal to the maximum rate of tax in effect under I.R.C. § 1 for taxable years beginning in such calendar year. See Treas. Reg. § 31.3402(g)-1(a)(4)(iv). The maximum rate of tax in effect for taxable years beginning in 2005 is 35 percent. Thus, the mandatory flat rate for supplemental wages in excess of \$1 million in a given taxable year is 35 percent and will remain at 35 percent until income tax rates change.

Special Rules for Determining Applicability of Mandatory Flat Rate Withholding

- Currently applicable procedures for the calculation of noncash fringe benefits of an employee (see Announcement 85-113) will continue to apply in determining the amount of supplemental wages for purposes of the mandatory flat rate withholding. If the noncash fringe benefit amounts are not wages subject to income tax withholding, then they are not included in regular wages or supplemental wages. See Preamble T.D. 927
- The final regulations specifically provide that income from disqualifying dispositions of shares of stock acquired pursuant to the exercise of statutory stock options is not included in supplemental wages. See Treas. Reg. § 31.3402(g)-1(a)(1)(iii).
- If a supplemental wage payment results in the total supplemental wage payments to the employee from the employer during the calendar year exceeding \$1,000,000, the amount of that payment in excess of \$1,000,000 (when added to the supplemental wage payments previously made in the calendar year) is subject to mandatory flat rate withholding. However, the final regulations permit employers to treat the entire amount of the payment that results in the employee receiving total supplemental wages of more than \$1,000,000 as subject to mandatory flat rate withholding. This treatment can apply on an employee-by-employee basis.
- The final regulations provide that, in determining the

amount of supplemental wages paid, salary deferral amounts are allocated to the gross regular wage payments or to the gross supplemental wage payments from which they are actually deducted.

Taking Into Account Payments by Agents of Employers in Determining Applicability of Mandatory Flat Rate Withholding

In determining whether the supplemental wages paid by an employer to an employee in a given taxable year exceed \$1,000,000, Treas. Reg. § 31.3402(g)-1(b)(8)(i)(b)(2) provides that an employer (the first employer) must consider wage payments made to the employee by any other person treated as a single employer with the first employer under I.R.C. § 52(a) or 52(b). Under Treas. Reg. § 31.3402(g)-1(a)(3)(ii), if an employer enlists a third party to make a payment to an employee on the employer's behalf, the payment will be considered as made by the employer even though it may have been delivered to the employee by the third party.

The final regulations generally retain the rule of the proposed regulations requiring that payments made by agents of the employers must be considered in determining the applicability of mandatory flat rate withholding. However, the final regulations provide relief in the form of an optional de minimis rule exception (subject to anti-abuse provisions). See Treas. Reg. § 31.3402(g)-1(a)(4)(iii).

Effective Date of Regulations:

The final regulations will be effective with respect to wages paid on or after January 1, 2007. Due to administrative burden concerns, the Treasury and IRS asked for comments to address employer concerns about the need to track when supplemental wages exceed the \$1,000,000 threshold.

V. Reporting Guidelines and Forms

A. Donated Leave is Income to Donor – Reportable and Subject to Withholding

In PLR 200626036 (March 7, 2006), the IRS ruled that the value of the vacation and other similar accrued leave transferred by State employees under a program allowing employees to donate such leave is reportable on the employee's Form W-2, and is subject to FICA tax, FUTA tax, and income tax withholding. Under the State sponsored program, employees can donate vacation and other similar accrued leave to the leave bank of a deceased State correctional guard or highway patrol officer who dies while in service but not in the line of duty. The State then pays the cash value of the donated leave to the survivor of the deceased guard or officer, not to exceed a specified amount.

Generally, under the assignment of income doctrine, a taxpayer's assignment of his or her right to receive compensation for personal services to another person does not relieve the taxpayer of the tax liability on the assigned income. See Lucas v. Earl, 281 U.S. 111 (1930). In this case, the value of the leave was income because the program did not meet the requirements of either of the two exceptions to this rule, Rev. Rul. 90-29, 1990-1 C.B. 11, allowing certain leave-sharing plans established by an employer for the benefit of employees that suffer medical emergencies, or Notice 2005-68, 2005-40 I.R.B. 622, allowing certain leave-based programs to aid victims of Hurricane Katrina.

B. D.C. Circuit Court: Section 104(a)(2) Unconstitutional in Taxation of Certain Nonphysical Injury Damage Awards

In Murphy v. IRS, 98 AFTR 2d 2006-XXXX, (Cal. Dist. Col. 2006), the Court of Appeals for the D.C. Circuit ruled that compensation for a non-physical personal injury is not income under the Sixteenth Amendment if it is unrelated to lost wages or earnings, and I.R.C. § 104(a)(2) is unconstitutional. Under the facts of the case, the taxpayer was awarded damages for emotional and mental anguish and injury to professional reputation stemming from a whistleblower suit she won against her former employer, the New York Air National Guard. The taxpayer claimed the award as gross income on her tax return, and paid the associated taxes due. On an amended return, Taxpayer claimed that she was entitled to a refund because her award was on account of personal injuries or physical sickness, and therefore was excluded from income under I.R.C. § 104(a)(2). The district court ruled that the damages were not excludable from income, and taxpayer appealed.

On appeal to the D.C. Circuit, the taxpayer argued that I.R.C. § 104(a)(2) was unconstitutional as applied to her. The taxpayer analogized her nonphysical injuries to the "restoration of capital," historically excluded from gross income. The D.C. Circuit ruled in favor of the taxpayer, and determined that the taxpayer's compensatory award was effectively for a loss of a personal attribute, and not in lieu of lost wages or other income. The court remanded the case to the district court with instructions to enter judgement in favor of the taxpayer, and ordered the government to refund the taxes she paid plus the applicable interest.

C. Form 3115 Accounting Method Instructions Revised

In Announcement 2006-52, 2006-33 I.R.B. 254, the IRS announces that the instructions for Form 3115, Application for Change in Accounting Method, have been revised as of May 2006. The May 2006 Instructions for Form 3115 incorporate changes made in published guidance such as Rev. Proc. 2004-34, 2004-22 I.R.B. 991 (regarding reporting advance payments) and Rev. Proc. 2006-1, 2006-1 I.R.B. 1 (regarding letter rulings). It also lists and describes automatic accounting method change numbers 77 through 103, and revises the descriptions of automatic accounting method change numbers 7, 8, and 9, to incorporate guidance published since the December 2003 version.

The May 2006 Instructions for Form 3115 and the December 2003 Form 3115 may be

downloaded at [www.irs.gov/formspubs/index.html](http://www.irs.gov/formspubs/index.html).

D. IRS Corrects Reporting Rules For Payments Made to Attorneys

The IRS issued corrections to T.D. 9270, relating to information reporting requirements for payments made to attorneys for legal services. The corrections were generally typographical in nature.

E. Specifications Updated for Electronic and Magnetic Filing

In Rev. Proc. 2006-33, 2006-32 I.R.B. 140 (August 3, 2006), superceding Rev. Proc. 2005-49, the IRS updated the specifications for the electronic or magnetic filing of Forms 1098, 1099, 5498, and W-2G. The publication also includes updated specifications for filing the forms through the IRS Filing Information Returns Electronically (FIRE) System or magnetically using IBM 3480, 3490, 3490E, 3590, or 3590E tape cartridges. More information on this system may be found at <http://fire.irs.gov>. The IRS noted that the electronic or magnetic filing systems no longer accept 3½-inch diskettes for filing information returns. The information found in this revenue procedure must be used for the preparation of tax year 2006 information returns as well as information returns from earlier years filed after January 1, 2007, and postmarked by December 1, 2007.

VI. Other Matters

A. Treasury/IRS Release 2006-2007 Priority Guidance Plan

On August 15, 2006, the Treasury and IRS issued the 2006-2007 priority guidance plan which lists guidance projects to be completed during the next twelve months. Notable projects include:

- Anticipated regulations relating to reserves for post-retirement medical and life insurance benefits under I.R.C. § 419A.
- Anticipated regulations on reporting and income tax withholding related to I.R.C. § 409A.
- Final regulations under I.R.C. § 3121 regarding the definition of a salary reduction agreement. Temporary regulations were published on November 16, 2004.
- Guidance under section 1398 and section 1115 of the Bankruptcy Code, as added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, regarding income tax and employment tax treatment of post-bankruptcy wages and self-employment income earned by an individual.

The Treasury/IRS 2006-2007 priority guidance plan can be viewed in full on the IRS website at

<http://www.irs.gov/pub/irs-utl/2006-2007pqp.pdf>.

VII. Ask the Experts . . .

A. How is Corporate Payee Status Determined for Purposes of the Information Reporting Requirements?

As described in the “Ask the Experts” column last month, generally information return requirements do not apply to payments to corporations of interest under I.R.C. § 6049, of dividends under I.R.C. § 6042, of general types of fixed or determinable income (except for attorneys’ fees or medical payments) under I.R.C. § 6041, or of sale proceeds by brokers under I.R.C. § 6045(a). What guidance do the regulations provide regarding substantiation of corporate payee status?

Treas. Reg. § 1.6049-4(c)(1)(ii)(A) provides that “[a]bsent actual knowledge otherwise, a payor may treat a payee as a corporation (and, therefore, as an exempt recipient) if one of the requirements of paragraph (c)(1)(ii)(A)(1), (2), (3), or (4), of this section are met before a payment is made.

(1) The name of the payee contains an unambiguous expression of corporate status that is Incorporated, Inc., Corporation, Corp., P.C., (but not Company or Co.) or contains the term *insurance company*, *indemnity company*, *reinsurance company*, or *assurance company*, or its name indicates that it is an entity listed as a per se corporation under § 301.7701-2(b)(8)(i) of this chapter.

(2) The payor has on file a corporate resolution or similar document clearly indicating corporate status. For this purpose, a similar document includes a copy of Form 8832, filed by the entity to elect classification as an association under § 301.7701-3(b) of this chapter.

(3) The payor receives a Form W-9 which includes an EIN and a statement from the payee that it is a domestic corporation.

(4) The payor receives a withholding certificate described in § 1.1441-1(e)(2)(i), that includes a certification that the person whose name is on the certificate is a foreign corporation.

Importantly, not all LLCs are treated as corporations for tax purposes. A single-member LLC that is a disregarded entity would have the status of its single member. Otherwise, an LLC could have a corporate status. Because disregarded-entity status would not be evident from the entity’s name, “LLC” is not “an unambiguous expression of corporate status,” as required by the regulation set out above. Thus, an executed Form W-9 showing status as a corporation would be appropriate documentation for a payor to treat an LLC as a corporation exempt under the general rule for information reporting. Form W-9 includes a check box to indicate status as a

corporation, and the certification language above the signature includes a statement that the named person is a U.S. person.

Scribner, Hall & Thompson's *Insurance Company Information Reporting and Withholding Update* now features a new "Ask the Experts" section giving readers the opportunity to ask "hypothetical" information reporting and withholding questions, and receive a response from the authors. One question and answer will be featured each month. Questions can be submitted to Lynlee Baker-Garbett by email at [Lbaker@scribnerhall.com](mailto:Lbaker@scribnerhall.com) or by calling 202-331-8585.

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