



Memorandum

Date: March 16, 2004
To: ECI
From: Bryan Cave LLP
Re: Recent Guidance Affecting 412(i) Plans

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On February 13, 2004, the Internal Revenue Service (“IRS”) issued guidance regarding the treatment of certain transactions involving life insurance policies held by qualified plans which it perceives as being abusive. This guidance consists of:

- (1) Proposed regulations under Section 402 of the Internal Revenue Code of 1986, as amended (“Code”), which would require that the fair market value of a life insurance policy distributed from a qualified plan be included in the participant’s income;
- (2) Rev. Proc. 2004-16, 2004-10 I.R.B., which provides interim rules for determining the fair market value of life insurance policies;
- (3) Rev. Rul. 2004-20, 2004-10 I.R.B., which holds that (a) a qualified plan does not satisfy Code Section 412(i) if it holds life insurance policies and annuity contracts that provide benefits in excess of a participant’s normal retirement benefit, and (b) employer contributions to a qualified plan used to purchase life insurance coverage for a participant that is greater than the death benefit under the plan may not be deducted when made; and
- (4) Rev. Rul. 2004-21, 2004-10 I.R.B., which holds that a qualified plan is discriminatory if the rights of nonhighly compensated employees to purchase life insurance policies on their lives from the plan are inherently less valuable than the rights of highly compensated employees.

While employers which sponsor Code Section 412(i) insurance contract plans (“412(i) plans”) will need to review the effect of all this guidance on their plans, this memorandum will discuss only Rev. Rul. 2004-20 due to its current impact on certain 412(i) plans.

Rev. Rul. 2004-20 requires immediate action by employers whose 412(i) plans are funded wholly or primarily with life insurance policies which provide death benefits in excess of 100 times a participant’s anticipated monthly normal retirement benefit (“excess coverage”).¹ In addition to

¹ A qualified plan may only provide incidental death benefits. Treas. Reg. § 1.401-1(b)(1)(i). A death benefit is considered incidental if it satisfies the 100 times limit described in the text or, in the alternative, if less than 50% of an employer’s contributions for a participant are used to purchase ordinary life insurance policies on

denying a current deduction for employer contributions used to purchase excess coverage, Rev. Rul. 2004-20 also designates those arrangements as “listed transactions” if the employer has deducted contributions used to pay premiums for excess coverage of more than \$100,000.

A listed transaction is defined in Treas. Reg. § 1.6011-4(b)(2) as a transaction which the IRS has identified in published guidance as a tax avoidance transaction. A taxpayer who engages in a listed transaction is required to file a disclosure statement with the IRS. Treas. Reg. § 1.6011-4(a). However, under Rev. Rul. 2004-20, even if a 412(i) plan provides excess coverage of more than \$100,000, the employer should not be engaged in a listed transaction if it does not deduct its contributions for the cost of the excess coverage.² Accordingly, as discussed in paragraph 1 below, an employer which established a 412(i) plan in 2003 should not be considered to have engaged in a listed transaction, assuming that it has not yet filed its return for 2003 (if it has filed that return, it would be treated in the manner described in the following sentence). An employer which maintains a 412(i) plan and has deducted contributions for premiums attributable to excess coverage of more than \$100,000 in prior years appears to have two options: (1) filing amended returns for open years³ to reverse those deductions, including a form 5330 to report a 10% penalty on nondeductible contributions (see paragraph 2); or (2) filing the required disclosure statement. Various considerations relating to these options are also discussed in more detail in paragraphs 2, 3 and 4 below.

1. Plans Established in 2003. In light of Rev. Rul. 2004-3, it is clear that deducting contributions attributable to the cost of excess coverage is a listed transaction, so all employers should limit the deduction on their 2003 returns (and any future returns) for contributions to their 412(i) plan to those which are not attributable to excess coverage. For that reason, in the case of a 412(i) plan established in 2003, the employer would not take any deduction described in Rev. Rul. 2004-20, and, thus, would not engage in a listed transaction. While the employer would have to

the participant’s life. Rev. Rul. 74-307, 1974-2 C.B. 126. A 412(i) plan that funds participants’ benefits with a combination of life insurance policies and annuity contracts satisfies the 50% limit if less than 50% of the aggregate employer contributions are used to purchase life insurance policies, even if the death benefit exceeds the 100 times limit. Only 412(i) plans subject to the 100 times limit (those plans where 50% or more of the aggregate employer contributions are used to purchase life insurance policies) should be affected by Rev. Rul. 2004-20.

² It is possible that the IRS could take the position that a listed transaction occurs if an employer deducts contributions used to pay any premiums on a life insurance policy providing excess coverage, even to the extent those premiums are not attributable to the cost of excess coverage. The applicable provision in Rev. Rul. 2004-20 states that there is a listed transaction if “the employer has deducted amounts used to pay premiums on a life insurance contract for a participant with a death benefit under the contract that exceeds the participant’s death benefit under the plan by more than \$100,000.” This language is not explicitly limited to deductions attributable to the cost of excess coverage. However, since the tax avoidance transaction identified by the IRS in Rev. Rul. 2004-20 is the deduction of contributions for excess coverage, *the better position* is that a listed transaction does not occur if the employer only deducts contributions attributable to the portion of the death benefit that does not constitute excess coverage.

³ An open year is taxable year for which the limitations period for the IRS to assess tax has not expired. Generally, a taxable year remains open until three years after the due date for the return for that year or, if later, the date the return is filed. Code Section 6501.

continue making nondeductible contributions in the future to properly fund the 412(i) plan, there is nothing in Rev. Rul. 2004-20 indicating that it would engage in a listed transaction as a result. The employer would, however, be subject to a penalty tax equal to 10% of the amount of the nondeductible contributions which would continue to be assessed each year until the amount in question can be deducted. Code Section 4972(a).

2. Amended Returns. With respect to plans established prior to 2003, the employer would have filed a return on which it took a deduction attributable to excess coverage. However, we believe that Rev. Rul. 2004-20 should not be interpreted to mean that the employer has necessarily engaged in a listed transaction simply because it previously filed a return claiming that deduction. Instead, a better interpretation is that this would constitute a listed transaction only if the employer derives a tax benefit from the transaction. Accordingly, if the employer files amended returns for any open years and reverses any deduction attributable to excess coverage, it should not be considered to have engaged in a listed transaction since it would not have taken an impermissible deduction for any taxable for which tax could be assessed.⁴ Any amended return(s) should be filed before the employer files its 2003 return because at that time the disclosure statement would be due⁵ the deductions that would otherwise give rise to a listed transaction would have been reversed. As discussed above in paragraph 1, the employer should be able to continue making nondeductible contributions to the 412(i) plan for excess coverage.

If the amended return is filed within 60 days before the limitations period for the taxable year would expire, that year will remain open until 60 days after the amended return is filed. Code Section 6501(c)(7). With that relatively minor exception, the limitations period is measured from the due date or filing date of the original return, and is not extended by filing an amended return. Zellerbach Paper Co. v. Helvering, 55 S. Ct. 127 (1934); Northern Anthracite Coal Co., 21 BTA 1116 (1931).

As an employer which does not take a deduction for contributions attributable to excess coverage for any open year should not be considered to have engaged in a listed transaction, it would not be required to file a disclosure statement.^{6/} While it is presently unclear what use the IRS is making of disclosure statements, presumably they could lead to heightened scrutiny of an employer's deductions attributable to excess coverage (and perhaps other aspects of its 412(i) plan and other items on its return) because, as a listed transaction, the employer is deemed to have engaged in a tax avoidance transaction. Accordingly, the advantage derived from filing amended returns to reverse those deductions is that the employer is more likely to avoid such scrutiny.

⁴ Even if the employer were considered to have engaged in a listed transaction because it took a deduction attributable to excess coverage only in a closed year (e.g., 1999), that would not require it to file a disclosure statement. If a transaction occurred in a year for which the taxpayer's return has already been filed, and the transaction subsequently becomes a listed transaction, a disclosure statement must be filed only if the limitations period for that year has not expired. Treas. Reg. 1.6011-4(e)(2)(i).

⁵ See paragraph 3 below regarding the filing requirements for the disclosure statement.

^{6/} As one of the principal purposes of filing a disclosure statement is to avoid penalties for underpayment of income tax (see paragraph 3 below), it would not make sense to do so where the deduction has not been taken and, therefore, the penalty cannot be assessed.

The obvious disadvantage of filing amended returns in this situation is that the reversal of the employer's deductions for its open years would increase its gross income and, if that results in additional taxable income, its income tax for those years. In addition, the employer would be subject to the 10% penalty tax on nondeductible contributions under Code Section 4972(a) for those years. This would require the employer to file a Form 5330 with its amended returns; interest and penalties may have to be paid for late filing of that form and late payment of the excise tax, though the penalties might not be imposed if the failure to file or pay on time is due to reasonable cause.

3. Disclosure Statement. If an employer has taken a deduction for contributions attributable to excess coverage for any open year, and does not file an amended return to reverse that deduction, it would have to file the disclosure statement required under Treas. Reg. § 1.6011-4(a) on Form 8886. Treas. Reg. § 1.6011-4(d). This form requires the taxpayer to identify the type of listed transaction that was engaged in, describe the transaction and the taxpayer's participation, describe the expected tax benefits and estimate the amount of the expected tax benefits for each affected taxable year (including prior and future years).

When a transaction which occurred in a prior year becomes a listed transaction after the taxpayer's return for the prior year is filed, but before expiration of the limitations period for that year, Form 8886 would have to be filed with the taxpayer's next return after the transaction becomes a listed transaction, regardless of whether the taxpayer engaged in the transaction in that year. Treas. Reg. § 1.6011-4(e)(2)(i). Accordingly, an employer which engaged in the listed transaction described in Rev. Rul. 2004-20 would have to file that Form 8886 with its 2003 return, or the next return due after February 13, 2004 for fiscal year taxpayers. That form would also have to be filed with the taxpayer's return for each subsequent taxable year in which it engaged in the listed transaction. At the time the first Form 8886 is filed with the taxpayer's return, a copy would also have to be filed with the Office of Tax Shelter Analysis. Treas. Reg. § 1.6011-4(e)(1).

Filing Form 8886 would not immediately require the employer to pay any additional income or penalty taxes. However, that would not protect the taxpayer from assessment of those taxes, and it would inform the IRS that the employer had made nondeductible contributions which might be disallowed on audit and, as discussed above, could perhaps lead to greater scrutiny of the employer's tax return.

There are no specific monetary penalties if an employer does not file Form 8886 when required to do so. However, failing to file Form 8886 could make it more likely that the employer would be subject to penalties for underpayment of income tax. A penalty equal to 20% of the underpayment is imposed if the underpayment is due to certain specified reasons, including negligence or disregard of rules or regulations, or an understatement of income tax for any taxable year which exceeds the greater of (i) 10% of the tax required to be shown on the return for the taxable year, or (ii) \$5,000. Code Section 6662. However, the penalty for an understatement due to disregarding rules or regulations will not apply if the taxpayer has a reasonable basis for its position and that position has been properly disclosed, which includes, in the case of a listed transaction, filing a disclosure statement in accordance with Treas. Reg. § 1.6011-4. Treas. Reg. § 1.6662-3(c)(1). In addition, the understatement penalty will not apply if the taxpayer can show reasonable cause and good faith with respect to the understatement. Code Section 6664(c). However, if the taxpayer

fails to file a disclosure statement with respect to a listed transaction, that is a strong indication that the taxpayer did not act in good faith. Treas. Reg. § 1.6664-4(d). Accordingly, if an employer fails to file Form 8886 regarding any deductions to its 412(i) plan attributable to excess coverage, it is unlikely to be able to assert a defense against any penalty due to an underpayment resulting from those deductions. Conversely, by filing Form 8886, the employer would at least preserve the possibility of arguing that it had a reasonable basis for its position and acted in good faith.

4. Cost of Excess Coverage. In order to appropriately limit its deductions for contributions for excess coverage for 2003 and future years, or to reverse those deductions for prior open years, an employer will have to determine the cost of excess coverage that may not be deducted. Rev. Rul. 2004-20 specifies the factors for determining that cost. For taxable years ending after December 31, 2001, the annual premium rates for each \$1,000 of life insurance protection set forth in Table 2001 published in Rev. Rul. 2002-8, 2002-1 C.B. 398, would generally be used. Under Table 2001, for example, the premium rate for an individual who is age 50 is \$2.30. If there was excess coverage of \$1,000,000 on this individual, the cost of that excess coverage would be \$2,300 (1,000 x \$2.30).

For taxable years ending prior to December 31, 2001, the P.S. 58 rates set forth in Rev. Rul. 55-747, 1955-2 C.B. 228, would be applicable. The P.S. 58 rates are considerably higher than the rates in Table 2001. For example, the P.S. 58 rate for a 50-year-old individual is \$9.22, so the cost of \$1,000,000 of excess coverage would be \$9,220.

In lieu of the rates in Table 2001 or the P.S. 58 rates, the current published premium rates charged by an insurer for individual one-year term life insurance available to all standard risks may be used for taxable years ending on or before December 31, 2003. However, for arrangements entered into after January 28, 2003, those rates may be used only if (i) the insurer generally makes the availability of those rates known to persons who apply for term insurance coverage, and (ii) it regularly sells term insurance at those rates to individuals through its normal distribution channels.