PART I

UPDATE AND REFRESHER

LISTED TRANSACTIONS CONNECTED WITH BENEFIT PLANS

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LISTED TRANSACTIONS UPDATE AND REFRESHER IN CONTEXT OF LOCALLY PROMOTED 412(i) PLANS AND 419A(f)(6) OR 419(e) PLANS

Initial Comments:

The presenter has two+ situations where the IRS has identified potential "Listed Transactions". The audits were over six months ago on both - and guess what? No assessment yet. "Listed Transactions" can produce frightful penalty exposure. As commented below, the IRS has no statutory authority to waive Listed Transactions Penalties. Are IRS Audit Agents "burying" their findings to prevent assessments (most IRS personnel I know believe the penalties are too draconian)? Your guess is as good as mine.

Setting the Stage

Local insurance agents and Pension/Benefit Consultants are or were (and if it is past tense there is fallout at the current time) promoting use of three types of benefit programs for which virtually no one in this room should allow their clients to enter into (assuming you have some control over it). And if you or your clients do enter into such a benefit program - you need to exercise extreme caution to protect both yourself and your client. The notorious three are:

1. IRC § 412(i) fully insured Defined Benefit Plan with excess life insurance death benefit coverage. This is, and has been, potentially a "listed transaction" (described later) since spring 2004 (Notice 2004-20). A 412(i) Plan is a "listed transaction" for a given tax year if the face value of the life insurance death benefit on the life of a participant paid under the Plan's terms to the Plan is more than $100,000 in excess of the maximum allowable death benefit for the Defined Benefit Pension Plan participant - and a deduction is taken for a contribution to the Plan for that year. If the policy face value exceeds the allowable death benefit, but is under the terms of the Plan payable to the participant, the Plan is not qualified under the Internal Revenue Code, but the literal wording of the IRS Listed Transaction Notice is not met. Is it a Listed Transaction? Some IRS personnel say yes but that might be worth litigating. Other problems include:

- Life insurance exceeding 50% of Plan assets (disqualifying feature) -these Plans must provide proper annuity policy coverage.
- Benefits provided under the annuity policy not equaling the benefits provided under the Plan document.
- Cash value life insurance benefits for owners - and term or "discriminatory" life insurance coverage for non-owners.
- Failure to cover sufficient personnel to pass coverage tests.

- Failure to implement annuity insurance benefit coverage during the Plan Year (the IRS position is the policy must be purchased <u>during</u> the applicable taxable year - <u>no</u> 81/2 month grace period to purchase policy even if the tax return is on extension (the full premium can be paid up until the return due date assuming the policy was in force as of the end of the tax year).

<u>Note</u> - This discussion will focus primarily on “listed transaction” issues.

2. <u>IRC § 419A(f)(6) Welfare Plans</u>. This is a type of “pooled” VEBA that is allegedly maintained by multiple employers. No one employer can contribute more than 10% of the total contributions. And the Plan will not qualify for any favorable tax deduction treatment if the Plan has “experience rated” arrangements under which each employer’s contributions and benefits are individually determined either on the contribution end or the benefit end - or both. A purported 419A(f)(6) Program that maintains experience rating for employers has been a “listed transaction” since <u>Notice 2002-15</u>. Other problems include:

- Contributions in excess of amounts deemed actuarially necessary to provide the cost of the death benefit (under “term coverage principles”).

- Severance or disability benefit features that are in effect, intended to operate as “non-qualified deferral compensation plans”. Deferred Compensation is <u>NOT</u> a permissible 419A(f)(6) benefit. <u>And</u> the Plan almost certainly can be deemed to violate IRC § 409A (a topic of its own).

- The Insurance Policies are almost always horrible economically: No one would buy them outside the context of a claimed big tax deduction.

- Funds are held by a third party trustee - out of client’s control. Think about the implications of that.

3. <u>419(e) Welfare Plan</u>. This is a <u>single</u> employer VEBA. Heavily promoted by insurance agents in recent years/months, deductions to this type of Plan were specifically limited in the Tax Reform Act of 1984 (see discussion in another portion of the presentation). The net import of these limits “killed” the single employer VEBA tax shelter market and led to the (largely abusive) 419A(f)(6) programs. IRC § 419(e)’s limits basically limit deductions to amounts the employer could otherwise deduct without the VEBA, with some minor exceptions. Post retirement medical and life insurance benefits cannot be funded to extent:

1. Life Insurance face value exceeds $50,000.
2. Benefits do not cover a nondiscriminatory classification (IRC § 505(b)).
3. Benefits for key-employees (owners - IRC 416(i)) must be allocated to a separate account and allocations to this account reduce the maximum per person allocation of $46,000 ($49,000 for 2009) to a 401(k) or other Defined Contribution Plan.

The typical 419(e)Program marketed to businesses as tax shelters was designated a listed transaction on October 17, 2007 in Notice 2007-83 - for fiscal years ending on or after November 5, 2007. The IRS required filing Form 8886 for all open years by January 15, 2008.

<u>What is a "listed transaction"?</u>

IRC § 6707A imposes penalties upon any person who fails to include information with respect to a "listed transaction" which is required under IRC § 6011 to be included on the return. The net impact of 6011 and 6707 is that a "listed transaction" must be reported on Form 8886 to avert the penalty under IRC § 6707A(b)(2).

A "listed transaction" is defined in IRC § 6707A(c)(2) as "a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary (of the Treasury) as a tax avoidance transaction for purposes of Section 6011".

<u>What is the Penalty</u>?

The penalty is (per <u>tax year</u>) $100,000 for a natural person and $200,000 for any other case.

<u>What triggers the Penalty?</u>

Deducting any amount ($1?) on an applicable return with respect to a "listed transaction" without filing Form 8886.

<u>How is the penalty calculated by IRS in the field?</u>

(Note: - this is based on current audit experience - trust me).

Sole proprietor - $100,000 per year.

C corporation - $200,000 per year (possibly penalty on shareholders if IRS successfully alleges "constructive dividend").

LLC/General Partnership - $100,000 per partner (assume taxed as a partnership).

S corporation - $200,000 on corporation, $100,000 per shareholder.

Example - 3 shareholders - $200,000 on “S” corporation, $300,000 on shareholders - Grand total - $500,000 per year!

Note - Notice 2007-83 indicated only 20% or more shareholders of a pass thru entity would get hit with the penalty, but based on conversations with the IRS that limit does not apply to 412(i) and 419(f)(6) related assessments because the prior notices for them did not contain the limits).

Can the Friendly IRS Agent Waive the Penalty?

Not on paper. See IRC § 6707A(d)(1). Congress barred the IRS from this discretion.

Can you appeal imposition of the penalty to US Tax Court or Federal District Court?

No. See IRC § 6707A(d)(2).

Can You Amend a Return to Add Form 8886 - and thus Avert the Listed Transaction Penalty? (this took some research and discussions with the IRS to dig out - the accounting profession is, per discussions with many, including Big Four, unaware of this).

Generally NO! See Reg 1. 6604 - 2(3)(ii).

The net import of this Reg (issued January 7, 2007) is that a “listed transaction” will be considered “undisclosed” unless Form 8886 is filed either on the original return or is filed with a “qualified amended return”. For purposes of a “listed transaction “ an amended return is not “qualified” unless filed before:

1. Date taxpayer is contacted by IRS for examination.

2. Date tax shelter promoter is contacted by IRS for examination under IRC § 6700 (penalty on promoter for promoting abusive shelters).

3. Date “pass-thru entity” is contacted by the IRS (for pass-thru tax item).

4. Date of summons to group including pass-thru entity or taxpayer.

5. Date by which Commissioner announces a settlement initiative with respect to a listed transaction.

Note - The IRS HAS announced, in previous years, settlement initiatives for 419(A(f)(6) Welfare Plans and 412(i) Defined Benefit Plans. Thus, window on these is closed. As to 419(e) Welfare Plans (single employer) - the January 15, 2008 deadline under Notice 2007-83 has passed, and it appears the opportunity to amend for prior open years as of Fall 2007 is past (but this might require careful review and further consideration).

Note - The Reg indicates Commissioner may waive the requirements of the settlement initiative bar. What does that mean? It means the IRS is not barred by Congress from waiving the settlement initiative prohibition - although in our experience thus far - IRS Field Agents and their immediate supervisors say "No". Appeal to IRS Appeals might be needed - we are not far enough in that pipeline yet to know what happens at Appeal.

6. Date IRS contacts any person under IRC § 6707 for failure to report a "reportable transaction".

7. Date IRS requests from any person who made a tax statement to or for benefit of taxpayer, or gave taxpayer material advice with respect to the information required to include on a list under IRC § 6112 relating to a transaction same or similar to the undisclosed listed transaction (IRC § 6112 relates to lists required to be maintained by material advisors (IRC § 6111)).

TOUCH CHOICES! Chart follows:

Situation	What to do?
1. Client enters into "listed transaction". You find out. Return not prepared or filed	Insist on attaching Form 8886 or backing out deductions or both: Explain reasons to Taxpayers. 8886 also goes in on 1040 for S corporation owners or LLC members. CYA if client refuses. Seriously consider revising returns to back out the affected deduction.
2. Client enters into "listed transactions". Returns filed without 8886.	412(i) or 419A(f)(6)

	Determine why you were unaware of "listed transactions" to measure exposure for 412(i) and 419A(f)(6). Measure "pros" of disclosing transaction on Form 8886 (guaranteed audit?) when there is only a small chance IRS Commissioner may waive the "listed transaction" penalty - and most likely backing out the deductions--or not disclosing - thereby playing the audit lottery (remember they can - and have - gotten the "promoters" list. I was told IRS got a list of most of BISYS's 419A(f)(6) clients and is auditing <u>all</u> - and locally many of you know Xelan's list is under audit) but having no chance of getting penalty waived. <u>NOTE</u> - Developing area. A middle step is not filing 8886 but amending to delete deductions (a "listed transaction" requires a "deduction"). We are currently testing whether that "works" - although an IRS Field Agent told me if "deduction taken on the original return, amending to delete it does not matter." <u>419(e) Single Employer VEBA</u>
	File amended return with 8886 - and for more protection - disallow deductions. <u>NOTE</u>- Per Notice 2007-83: file Form 8886 for all open years as of Fall 2007 - deadline to file was January 15, 2008.

<u>Do Taxpayers and or Promoters Usually Blame the CPA for the Imposition of a "listed transaction penalty</u>?

Absolutely! In experience of BUTTERFIELD SCHECHTER ◆LLP, in co with IRS audits and litigation against the promoter of these abusive employee benefit products - standard litany is: "we just sold the product and the plan, the filing of the Form 8886 is your accountant's responsibility"! Even though the client usually is clueless as to what a "listed transaction" is - much less able to articulate to his/her CPA the fact he/she entered into an abusive tax shelter.

Note - Virtually all of these deals involve an insurance or financial person promoting these deals, assuring the client of wonderful tax write-offs and great financial/tax benefits and at the last moment (see form later) asking client to sign - in the flurry of paperwork needed to sign up for the program - to sign a disclaimer form to protect the promoter - the form usually says "you did not rely on the promoter for tax advice, obtained independent advice," and some also indicate "the transaction might be a listed transaction" (see later slide). There are almost never any oral disclosures - or written disclosures prior to the final signing session - to the effect that the client is entering into an abusive tax shelter and that penalties in the hundreds of thousands of $s can be imposed for failure to file Form 8886.

Note 2 - Virtually all (with exceptions) of the deals we've seen involve a CPA who just is "given pension/benefit #s" - and is uninvolved in the consulting process and also unaware of the nature of the particular benefit plan. The CPA claims ignorance of the situation - indicating he/she had no idea what taxpayer did was a "listed transaction" or was considered abusive in any way. This results in UGLY finger pointing situations - and possible litigation. Clients turn mean and nasty when penalties in the hundreds of thousands are imposed.

Examples of the Ugliness

Our firm has numerous examples of disclosure forms taxpayers sign, and litigation postures. A sampling follows (actual form):

“TAXPAYER DISCLOSURE OF LISTED TRANSACTION

Name of Employer: ____

Federal Identification Number: _______________________

Name of Plan: ____________________________________

Plan Administrator: ________________________________

____

I, the undersigned on behalf of the employer named above, hereinafter called the “EMPLOYER”, hereby acknowledge and agree as follows:

1. I am duly authorized and empowered to execute this Acknowledgment and Waiver on behalf of said EMPLOYER;

2. The EMPLOYER has established a welfare benefit plan under the provisions of Internal Revenue Code section 419A(f)(6), and the Penn Mutual Life Insurance Company has issued or will issue life insurance policy(s) pursuant to the terms and provisions of said plan;

3. Under the provisions of Internal Revenue Code section 6011 and the Regulations thereunder, welfare benefit plans purporting to comply with the provisions of Internal Revenue Code section 419A(f)96) may be considered “listed transactions”, and therefore, the EMPLOYER may be required to file IRS Form 8886 - Reportable Transaction Disclosure Statement with its federal income tax return;

4. The provisions of American Jobs Creation Act of 2004 enacted on October 22, 2004 impose substantial monetary fines and tax penalties for noncompliance with the taxpayer disclosure requirements of Internal Revenue Code section 6011;

5. The EMPLOYER has relied solely and exclusively on the opinion and advise of its independent legal and tax advisors with respect to all matters relating to said plan, including, but not limited to the disclosure requirements and tax consequences of said plan;

6. Neither the Penn Mutual Life Insurance Company nor any of its agents, representatives, or employees have provided any legal or tax opinion or advise with respect to the tax consequences of the plan, taxpayer disclosure requirements, or the application and effect of the Employee Retirement Income Security Act of 1974 (ERISA) respecting the plan;

7. The undersigned EMPLOYER hereby agrees to indemnify and hold harmless the Penn Mutual Life Insurance Company and its agents, representatives, or employees from any and all liability obligation or responsibility whatsoever directly or indirectly relating to or resulting from the establishment, operation, or administration of the plan, the taxpayer disclosure requirements respecting said plan or the fines and penalties for noncompliance with said disclosure requirements and the tax consequences of said plan.

Date: ____________________ NAME OF EMPLOYER

ATTEST: SIGNED: ________________________

TITLE: ________________________

RELATED
SEE DISCUSSION ON THIS TYPE OF FORM

And in litigation, the insurance company usually claims its agent was a "cowboy" - acting improperly. See the following excerpt from Hartford Insurance Company's "answer" in litigation:

"THIRD AFFIRMATIVE DEFENSE

No Reasonable Reliance

Defendants assert that Plaintiffs had the resources to engage, and did in fact engage, the services of independent advisors and experts to advise and assist them in conjunction with the events alleged in the Complaint. Defendants allege that Plaintiffs relied upon the advise and expertise of their own advisors in connection with the activities alleged in the Complaint. In addition, Defendants allege that Plaintiffs took tax deductions for Welfare benefit plan contributions and took other actions knowing they freely and voluntarily assumed the tax risks and other risks and consequential injuries and damages, if any, and could not and did not reasonably rely on any purported misrepresentation, inaction, advise or purported expertise of Defendants."

<u>What can you do to protect yourself</u> Given the new paradigm that Insurance Agents - at least in this arena - are <u>not your friends</u>, <u>are not fiduciaries of the taxpayer</u>, and are hell-bent to market and sell abusive tax <u>shelters to you and your clients - knowingly or not</u>?

<u>NOTE</u> - Given some CPAs now sell product - participating in the advising and promotion of this type of Program from an investment fee perspective means litigators will almost certainly want to name you as a party Defendant. As it stands, even if you have no involvement in the investment side of this - you are likely to be named as a Defendant.

COVER YOUR BUTT!!!! Consider two things:

1. Amend your engagement letter (this is unlikely to work if you materially participated in the consulting and/or investment side of the listed transaction) to say something to the effect:

Acme CPAs does not in the gathering of data to prepare your returns (1040, 1120, 1065, etc.) independently investigate to determine whether the contributions reported to us by your Qualified Plan or Benefit Program Consultants, Insurance Agent or Third Party Administrators are to a program designated by the IRS as a "listed transaction" (i.e. abusive tax shelter). Penalties for unreported "listed transactions" can be $200,000 or more per year.

We merely take information from others - the tax qualifications and other attributes of the benefit programs you contribute to are not our responsibility. Our firm can assist you upon request to review your benefit programs - and we will if deemed advisable - assist you to obtain independent advice from qualified benefit advisors. The types of benefit programs particularly susceptible to "listed transaction" penalties generally are (1) 412(i) fully insured Defined Benefit Plans with life insurance (2) 419A(f)(6) multiemployer Welfare/VEBA Plans and (3) single employer 419(e) Welfare/VEBA Plans (not a complete list).

2. <u>Annual Questions in your Questionnaire to Clients</u>:

<u>Examples</u>:

1. Did you establish or do you maintain any benefit plans of the following types during 2007?

A. 412(i) fully insured Defined Benefit Plan with life insurance. Yes ____ No

B. 419A(f)(6) Welfare Plan/VEBA. Yes ____ No

C. 419(e) Welfare Plan/VEBA. Yes ____ No

D. Any other type of benefit program involving life insurance or disability insurance premiums other than a "plain vanilla broad coverage" Section 79 Group life insurance plan or group disability plan.
Yes ____ No

3. <u>Get Suspicious</u>!

Do you have a client 32 years old whose Pension consultant sends you a letter telling you the 2007 pension deduction is $200,000+ (even $100,000+)? Do you have a client who is deducting any amount to a benefit program that involves life insurance above and beyond any "vanilla" nominal amounts? Has the Pension consultant told you your client can put in large amounts into benefit programs solely benefiting your client without covering other employees you think normally would be covered under a typical 401(k) Plan? Are you hearing anything that sounds "too good to be true?" Is someone telling you he/she has a benefit program few know about - and that he/she alone in the USA possesses knowledge about big deductions to benefit plans that no one else has?

A <u>YES</u> - to any or all of the above questions should lead you to ask yourself whether further investigation or added "CYAing" is advisable.

REMEMBER - the $ stakes are huge here!! A client subjected to huge listed transaction penalties is likely to turn into an ugly Plaintiff. And your malpractice policy may or may not cover you for amounts you owe after a Court battle for "listed transactions." You may believe overlooking "listed transactions" is not negligence. But I guarantee you some Courts and Juries will not see it that way. Do you want to "play chicken" with these penalties? Not advised!!

Part II. <u>FALLOUT OF SOME 412(i) and 419(e) MATTERS</u>

1. <u>Actual Situation in Use of Insurance Company Disclaimer Form</u>:

Recent case in Federal District Court (handled by my firm). <u>Omni Home Financing</u> v. <u>Hartford Life and Annuity Insurance Co</u>. 4-29-08.

Remember the “form letter” in Part I that I highlighted? That was a real letter signed by a Company we worked with. Another Company we worked on signed a similar form from Harford.

Company was damaged significantly by a defective 412(i) Plan promoted by Hartford’s agents.

Synopsis of Court Ruling

The mortgage brokerage firm began meeting with representatives from Hartford in early 2003 to discuss the creation of a Section 412(i) defined benefit plan. A financial adviser who worked with the Company principals in their personal investments and a Hartford account executive presented a plan proposal to the Company that included statements that the plan would be tax deductible, the court said.

During the meetings, a plan trustee and Company officer signed documents that included statements that the account executive and Hartford did not provide a tax or legal advice, and also included information about the tax treatment of Section 412(i) plans, the court added. The Company adopted the plan in December 2003 and Hartford issued insurance policies to the plan.

The Company subsequently took $420,000 in deductions in 2003 and 2004 for contributions it made to the plan. The Internal Revenue Service disallowed the deductions after an audit revealed that the plan did not comply with several requirements for qualified plans. Thereafter, the Company and three of its principal employees and plan participants filed a lawsuit against Hartford and the agent alleging, among other things, breach of fiduciary duty under ERISA, and fraud, deceit, and misrepresentation in violation of state law. Hartford and the agent filed a motion, contending they were not fiduciaries under ERISA.

According to the court, for a person to be considered a fiduciary under ERISA, that person must provide investment advice for a fee on a regular basis, pursuant to a mutual understanding, and the advice must pertain to the value of the property or consist of recommendations as to the advisability of investing in certain property. The court found that the Agent did not provide advice on a regular basis, and may not have even provided investment advice.

According to the Department of Labor’s regulations, investment advice is advice to the plan as the value of, or whether to purchase, sell or invest in securities or other property. The Agent advised the Company to fund the Section 412(i) plan with Hartford insurance products and take corresponding tax deductions, which may not qualify as investment advice, the court said. Even if it was investment advice, the court said it was only provided at the outset of the plan, and thus did not meet the regular basis requirement of fiduciary status.

The court similarly found that the non-Hartford financial planner was not an ERISA fiduciary because his advice did not serve as the primary basis for Omni's investment decision. According to the court, it was the Hartford Agent's interpretation of the deductibility of contributions to the plan that was the primary basis for the Company's investment decision. Furthermore, even if the financial planner's role was to give investment advice with the Hartford Agent, he also did not meet the regular basis requirement for ERISA fiduciary status, the court said. Moreover, although the financial planner was a fiduciary with respect to the Company's principals, that did not make him a fiduciary with regard to the plan, the court added.

The court also granted summary judgment to Hartford on the Company's state law claims. In so doing, the court said the Company failed to show that it reasonably relied on the misrepresentations of Hartford and the Agent because the plan trustee signed multiple documents acknowledging that Hartford and the Agent did not provide tax or legal advice, and that included disclaimers regarding the tax rules for Section 412(i) plans. The trustee argued that he never read the documents, instead relying on the expertise of the Hartford Agent.

According to the court, under California law, reasonable reliance ordinarily cannot be shown when written documents contradict alleged oral misrepresentations. The disclaimers the trustee signed clearly explained that the Company should not rely on Hartford and the Agent for legal and tax advice, the documents were not long in length and thus were not burdensome to read, and the Company principals were sophisticated business people, the court said. As such, the Company could not show reasonable reliance, the court ruled.

The case is now on Appeal. We will keep you posted.

<u>WATCHWORD</u>: <u>Never</u> knowingly let your client enter into a transaction involving a financial institution, insurance company, etc. where such a form is to be signed (getting independent advice is always the best practice even if a form like that is not presented). And if you hear of such a transaction, consider warning your client to not sign forms like this and to get independent advice. If they have signed this, get independent advice ASAP to consider whether to develop an exit strategy. The Insurance Company, etc. is not likely to stand behind its written brochures, its oral representations, even its written advice and because your client signed this form there is a good chance the insurance company will prevail in court. Where does insurance company success in court leave you? The unhappy client Company may focus on the other parties who knew of and were involved in the provision of services in settling up the plan – namely the Accountant, the lawyer and the third party Pension Administrator. Be careful!

2. Actual Claims in 419(e) Malpractice Case.

Our firm is currently suing a local tax practitioner over a disallowed deduction to a 419(e) Welfare Plan.

Facts: Company was told there was a method you could get a deduction to a single employer Welfare Plan for contributions to fund a life insurance death benefit for the Company owner. Keep in mind IRC § 419 limits deductions to the "qualified cost" as defined in Section 419. There were other employees involved in this overall group – so the "qualified asset account" treatment under IRC § 419A was not available. Also keep in mind that Notice 2007-83 not only made the 419(e) insurance situation a listed transaction, but pointed out such contributions have not been deductible since the Tax Reform Act of 1984! And that is no surprise – all the responsible ERISA practitioners I know concur! But some lawyers and insurance agents thought they spotted a loophole, wanted to sell Welfare Plans and insurance, and created the situation we see today.

"Qualified direct cost" (IRC § 419(c)(3)) is "the amount on cash method that would be deductible if the employer provided benefits directly."

The tax practitioner's defense was that the funds are irrevocably transferred to the Welfare Plan, thus if the employer had irrevocably transferred the funds to someone, the amounts were deductible and thus the rule is complied with.

Problem with the theory. This is not where a corporation transfers a life insurance policy to an executive and pays the premium. That is clearly taxable compensation, deductible to the corporation and income to the executive. The Company is contributing to a Welfare Fund that has pooled funds, is unvested, or is potentionaly forfeited if the executive does not die before the benefit is terminated (Welfare Benefits typically are unvested) and the Company has a potential future benefit by being able to shift those funds to provide benefits to other employees. The funds are not irrevocably committed.

3. Burden of Proof in Tax Malpractice

Another claim in tax malpractice by the Defendant is "you settled with the IRS too quick - if you took it to Tax Court you would have won."

Settled law is the burden of proof switches to the Defendant to prove the IRS was wrong in a case where the IRS has disallowed a deduction. Taxpayers who believe a tax practitioner committed malpractice do not have to litigate the case through Tax Court and beyond to establish malpractice. The burden is on the Defendant to prove the IRS improperly disallowed the deduction and/or imposed penalties.

Comment – Most claims in that nature are "bluster", but occasionally the IRS will get it wrong and if you are still involved, your best bet is to encourage the taxpayer to Appeal to higher levels. Perhaps you should do it for a reduced fee if appropriate (or no fee if you lose on Appeal). My partner Marc and I see no hope of prevailing on Appeal to IRS Appeals or Tax Court in 419(e) deduction cases.

4. Notice 2007 – 84 also highlighted potential abuses in 419(e) Post Retirement Plans.

Recent Activity – Some financial outfits/financial planners/lawyers are promoting post – retirement medical benefit and life insurance benefit plans (rules limit life insurance to $50,000 of coverage)! Such need to, per IRC § 419A(e), be nondiscriminatory. The Plan must meet the nondiscrimination rules of IRC § 505(b) (similar but not identical to qualified plan rules). The "pitch" is "wink-wink", "you will terminate the business or all employees before they reach retirement age, and thus no one but the owners will get anything."

Comments:

1. The IRS is aware of the "wink-wink" marketing.
2. Getting a favorable ruling on a Plan like this promise to be difficult.
3. Proof is in the pudding – its unclear what the IRS might claim years later upon audit when no one but the owner has ever benefited – assuming you got the initial ruling. Notice 2007-84 says "the tax benefit rule may require that some or all of the deductions taken by the employer in earlier years be included in its income in later years when an event occurs that is fundamentally inconsistent with the premise on which the deductions were initially based." The IRS Notice also points out 100% excise tax of IRC § 4976 might apply, and that various penalties would apply to the taxpayer and promoter.
4. Exit strategy to get the funds out to the owner is somewhat murky, especially if funding is for medical benefits that may or may not be used (due to outside insurance, Medicare, dropping dead suddenly with no long illness using Welfare Plan funds).
5. Life insurance and other investments sold by the promoters might not be favorable.
6. Last but not least – Any amounts allocated to a "key employee" under IRC § 419 for post-retirement medical benefits counts against the IRC § 415 limits. Example – Owner of business sets up a Post Retirement Medical Welfare Plan for 2008 and has $40,000 allocated to this mandatory account (for a "key employee") in the Welfare Plan for his/her post retirement medical benefits. This $40,000 counts against the maximum 401(k) allocation of $46,000 (catch-up is on top of it). You cannot do both.

I "disapprovingly" (against my advice) saw one company do this instead of a 401(k) Plan even though they could have put in a reasonably small amount for "non-owners" in the 401(k) Plan and still projected $46,000 for the owner in the 401(k). The owner went for the "pitch" that he could put in comparable amounts of $ into a Welfare Plan for benefits, and no other employee would ever get anything, even though the actuarial funding for the others was significantly in excess of the contributed nonowner 401(k) allocations..

Part III BENEFIT STRATEGIES UNDER IRS/FTB ATTACK

A. Local Strategies Under IRS Attack:

Comment The IRS has since the November 2007 meeting, stepped up greatly its audits of benefit strategies of several local practitioners. These are strategies I have been discussing at Tax Institutes for several years. I learned of some of these strategies 7-8 years ago and have counseled numerous clients and potential clients to steer clear. Also, have conferred with a number of local lawyers and accountants to advise them to steer clear as well. My understanding is there are at least FIVE local practitioners the IRS is focusing on, and there are undoubtedly more. There are others in the Los Angeles area who use these or similar strategies. The local practitioners are typically CPA firms or financial firms who also prepare tax returns (and may have lawyers on staff) or law firms with CPAs who prepare tax returns. The IRS through tax preparer lists and other techniques appears to have identified hundreds of audit targets and in fact is auditing many taxpayers. My firm is involved in a number of audits, assisting other firms who are handling these audits, or aware of other firms who handle audits without our involvement.

Strategy # 1 One or more local practitioners promote the following strategy:

1. Client creates management or consulting firm (Company B)–apart from the operating company (Company A) with employees.

2. Company B is owned by an irrevocable trust, with the trustee and beneficiary of the trust a relative or friend of Company A owner–it really does not matter who the other owner is (i.e. a total stranger owing it does not improve the result–might make it worse).

3. Company A contracts with Company B for management marketing and/or consulting services and shifts money to Company B.

4. Company B employs Company B's owner and pays him/her salary. Company B establishes a Defined Benefit Plan and/or a 419(e) Welfare Plan. Company A employees not covered under Defined Benefit Plan. The Defined Benefit Plan occasionally is a 412(i) fully insured plan.

Does it work? NO.

Local IRS audit branch is aware of this strategy and is actively auditing companies and identifying audit candidates. A treatise could be written on why it does not work but here are comments:

1. Substance over form. Irrevocable Trust exercises little or no control over Company B management–and derives little or no economic benefits. Company A's owner controls Company B–lock, stock and barrel! In short, the ownership is a sham.

2. Company B employee is a leased employee with respect to most, if not all, of his/her services for Company A. IRC § 414(n) aggregates "leased" employees with the recipient–and no ownership connection need be present. Also see *Kawesch* case in which a charge leveled by IRS against him was that payments to a separate marketing corporation were not fully justified as a deduction (i.e. the deduction of payments from A to B could be challenged).

3. Company B also is likely to be a "management corporation" under IRC § 414(m)(5). This again requires no ownership connection. Thus aggregation rule is intended to aggregate the "incorporated" (a corporation is not needed for the rule to apply) executive to be aggregated with the Company he/she manages or consults with–if the relationship is exclusive or over 50% of its activities (a bona fide management consultant need not fear § 414(m)(5)).

4. Company B's employee is also not likely to pass the "common law employee" tests–and be treated as employee's of Company A. See Rev. Proc. 2002-21 under which IRS rules "leased" employees are common law employees of the recipient entity.

5. The 412(i) Plan also has issues relative to compliance with the technical rules of IRC §412(i) (see discussion elsewhere) and typically has a "highly loaded" life insurance policy. The Plan is disqualified either way due to the "coverage" compliance failures, but the amount and type of life insurance coverage can cause a "listed transaction" to be found. See discussion elsewhere about the danger of listed transaction in this context.

6. The 419(e) Welfare Plan also usually involves a highly loaded life insurance policy. There are "listed transaction" implications discussed elsewhere. And the deduction is disallowed due to reasons discussed elsewhere.

Comment 1–This structure has been proposed to lawyers, MDs and accountants–who have been advised to shift most or all of practice income to a *non*-professional corporation–as "consulting" or "management" services. Really now, I am managing myself or consulting to myself? While simultaneously practicing? Professional regulators might be interested in these violations of professional entity rules.

Comment 2–The arrangements I have seen also have little or no structure–no visible management or consulting contracts–just a vague "funneling" of income on an "as needed," "as wanted" basis. Certainly not conducive to a defense against IRS attack.

Comment 3–Promoters also claim to have an "IRS Determination Letter." Do you know what an IRS letter means? A favorable letter on a Pension document refers solely to the document! The IRS is not (repeat NOT) made aware of, or ruling on, the

Company A/Company B structure and the exclusion of Company A employees from Company B's Qualified Plan (the Plan really is NOT qualified).

Comment 4–The IRS is attacking this structure, possibly seeking sanctions against promoters too. BE CAREFUL! BE SMART! If it is too good to be true, then it is not true! Don't you think if this is really worked, that everyone would be doing it? Would not we be reading about it in Forbes, the Wall Street Journal, Professional Seminars, etc.? Want to have clients under IRS investigation (possible tax fraud allegations) and face lawsuits for malpractice? If so, those of you doing this keep doing it. There are those of us who know its wrong and will continue to speak against it.

Strategy #2

1. Similar variation of Strategy #1 except there are two side corporations:

- California corporation #1 owned by same people who own corporation # 2 below – employees work here.
- California corporation #2 owned by same owners as corporation #1 with Pension Plan covering owners only (how the lawyer though that flew is a mystery)
- California corporation with Pension Plan owned by an irrevocable trust

The addition of the second corporation with the same owners is a true anomaly – as the practitioner had to have realized the entity would be a controlled group. Yet – its one of the "models". No way you can fund for two pension plans both with maximum benefits in same "family".

Strategy #3

Sometimes used with Strategy #1 – there also is another corporation that started out as an S corporation – usually prior to March 2001 – that adopted an ESOP – for some reason the promoter believed it would not be aggregated with the "mother corporation" using mathematical tests (see earlier discussion of IRS theories).

- Main corporation with non-owner employees
- Management Company owned by Irrevocable Trust
- S corporation owned by ESOP – with revenue source from royalties of intellectual property or other services coming from "main corporation".

The ESOP is converted to a Profit Sharing Plan as of December 31, 2004 when the law changed on ownership of S corporation stock through ESOPs (due to expiration of a grace period under EGTRRA). The corporation remained an S corporation past 2004.

IRS position: IRS attacks this arrangement for all the reasons outlined in Strategy #1, plus claims the conversion to a PSP was not done per IRS regulations thereby creating a “non allocation” under IRC §409(p) – generating a 50% excise tax on amounts in the ESOP.

Strategy #4 Get this! Local CPA firm sets up two corporations –

1. California – employees are here – No Pension
2. Nevada – owners here – Pension

Ownership of both is same – it’s a controlled group for sure – no need for any other theories of attack.

Comment – The CPA firm thought using a Nevada corporation hides from the IRS? What were they thinking? The IRS has the tax preparer list and is working on it.

Strategy #5 Los Angeles County based practitioner who reportedly has dozens of local clients (I am involved in one audit).

- Incorporated business
- Set up 419(e) Plan and Defined Benefit Pension Plan
- Don’t hire an actuary, just put in whatever you want and deduct it.
- Don’t cover any employees.

Example - a 32 year old professional advised to put over $600,000 annually into a Defined Benefit Plan.

Comment – Completely indefensible – what were they thinking?

Comments on IRS Settlement Postures and Best Protecting Your Takeover Client

The IRS has attempted to adopt a uniform settlement posture. The settlement proposals have evolved over the past 11 months to something that appears to be “solidifying” now. We are about to confer with the IRS on some closing agreements – so “we will see”.

Comment – The IRS position is that everyone gets about the same “deal”. No one practitioner is supposed to be getting “better deals”. Experience helps in dealing with the IRS on this, but no one can honestly state he/she can get a better deal from the Agent than other lawyers/CPAs in town can get. Of course, its my belief the IRS will respond better to polite treatment. Taxpayers or practitioners who contest the IRS positions, or treat the IRS with less than respect, might find themselves with less favorable treatment.

Comment #2 – At least one tax practitioner involved in promoting one or more of these arrangements claims to have a “back door” channel within the IRS to go directly to high level out of town IRS personnel to get better settlements than the settlements offered by the local Agents. DON’T BUY IT!! I have checked it out carefully and it’s not true! All settlements are going through and orchestrated by an IRS Southern California supervisory team for quality control and consistency. There is no back channel! The individuals purportedly involved in the back channel are actually part of the Southern California based IRS "team" (even though they may be in Texas, Virginia, Washington D.C. or wherever).

Three Basic Options

1. Contest the IRS determinations and go "unagreed". Comment is that the IRS is looking for test cases – and any taxpayer who challenges the IRS's basic deduction disallowances will find the IRS assessing every possible tax and penalty, closing the case out and kicking it up to Appeals - and Tax Court.

My View – Lots of luck on Appeal and Tax Court – you will need it! My guess is the taxpayer will waste thousands on legal and expert witness fees, lose and face taxes and many nonwaivable penalties.

2. Settle the Case on terms similar to the following:

(Note – no comment is made regarding settlement of disallowed lease, entertainment and other business level deductions – those are often at issue based on advice proved by one or more of these practitioners. I focus on benefit related items).

A. ESOP Disqualifications

- 409(p) non-allocation year - 50% excise tax waived. This was as much as $2 million in one case I am involved in – and is possible only if the ESOP is disallowed from inception
- Deduction allowed (its an S corporation flow through with ESOP)
- All amounts in ESOP as of date ESOP is closed down (this year including post market crash) are taxable income to taxpayer in 2006.
- 20% accuracy related, etc. penalty applies for 2006 on ESOP 1040 income.

Comment – An earlier IRS "Global Settlement Initiative" regarding S corporation ESOPs has tied the IRS hands, and in spite of valiant efforts – we have not been able to get past high level East Coast IRS personnel who insist the penalty must be imposed.

B. 419(e) Welfare Plans

- Deduction Allowed
- All amounts distributed from 419(e) Plan (surrender charges disregarded to my knowledge so far) in 2008 or 2009 are taxed in 2006.

- <u>No</u> 20% accuracy or negligence penalties assessed <u>if</u> the case was in the pipeline and under IRS review as of August/September or so (not sure of the date). The IRS changed a prior less favorable settlement position – and its my understanding for new cases opened recently, the 20% penalty will be assessed.

C. Defined Benefit Pension Plans (non 412(i))

- Deduction Allowed
- All amounts distributed from Pension Plan (surrender charges on life insurance, if any, disregarded to my knowledge – still checking) in 2008 or 2009 are taxed in <u>2006</u>. Current values upon distribution are used to measure 2006 income.
- <u>No</u> 20% accuracy or negligence penalties assessed <u>if</u> the case was in the pipeline and under IRS review as of August/September or so (not sure of the date). The IRS changed a prior less favorable settlement position – and its my understanding for new cases opened recently, the 20% penalty will be assessed.

<u>Note</u> – The IRS will not prepare the Closing Agreement on any of the benefits types until the Plan is closed out, the funds are distributed to the individual and the IRS has <u>proof</u> of the amount distributed and the amount now residing in a personal account in the taxpayer's own name(s).

D. 412(i) Defined Benefit Plans (fully insured)

Same as "C" above for Defined Benefit Plans except the penalty waiver is less likely to occur due to a prior "GSI" (see prior comment regarding impact of a prior GSI in a particular area of disallowance) <u>and</u> there may be a referral to another branch of the IRS to work up a "listed transaction" assessment. I have one case where we are praying this assessment gets lost in the IRS maze, although we do plan to attempt to contest it as being slightly different than the exact fact pattern detailed in <u>Notice 2004-20</u>.

3. Agree to IRS Position on Plan closure and all issues <u>but</u> the <u>penalties</u>. It appears the IRS will not require an all or nothing approach – i.e. you can agree to the plan closeouts, the 2006 treatment and still attempt to reduce or eliminate the 20% penalty on Appeal to the IRS Appeals Branch or U.S. Tax Court. Will let you know how that goes (I have two cases like this where closing agreements will be done soon and we will appeal penalties). Local IRS personnel are not unsympathetic to appealing penalties on Plan matters.

Comment to All Three Methods

1. The settlements are generally based on full pay. Installment payments are frowned upon. Its unclear whether you can settle favorably without full pay, although we are in discussions with the IRS on one case where an ESOP had most of its $ tied up in illiquid real estate. We might be able to work out an installment agreement – not sure yet.

2. The “management corporation(s)” owned by the Irrevocable Trust will be a “disregarded” entity – all its activity is transferred back to the central entity with employees and non pension/welfare plan items are or are not deductible based on the treatment there. The IRS will not treat anything as salary in the central entity if it was not salary in the management entity.

3. The IRS is not likely to waive penalties on non-pension benefit deduction disallowances. IRS view is that pension/benefit issues were highly technical and perhaps its possible the IRS could believe the taxpayer was an “innocent babe in the woods” misled by an outwardly believable practitioner. The IRS takes a different view toward deducting personal expenses, or having the corporation pay rent for use of your house without declaring the income on Schedule E.

4. The settlement postures outlined above do not, as of yet, apply to taxpayers victimized by the Los Angeles based tax advisor I referred to for Strategy #5. This is in a different IRS jurisdiction than the San Diego County based tax practitioners – so penalty exposure and tax treatments are still a pending item from my experience. Not far enough along yet to be able to report anything.

5. All in all though – it is possible to report the following:

- Strategies like this do not work.
- Be extremely careful in designing anything that could potentially result in a similar fact pattern.

  Note – The IRS has been also asserting that marketing, promotion, sales and similar services are “management services” for aggregation purposes of IRC § 414(m)(5).

- Do not underestimate the ability of the IRS to, from various sources, identify practitioners who are promoting these arrangements.
- Remember the IRS’s ability to produce a list of all of a tax preparer’s clients with some computer strokes.
- Do not underestimate the IRS’s willingness to use subpoenas and summons to seek tax practitioner client lists

- Be wary of entering into an arrangement like this with the belief the “odds are good” – remember IRS profiling, and entity level client list production.
- Be wary of entering into an arrangement like this when the belief that “no problem – if it does not work – will sue him/her”. Don’t forget the practitioner might have multiple claims and limited insurance coverage or no coverage, with perhaps limited attachable personal assets.

<u>Comment</u> – I actually consulted 2-3 years ago with a guy who did one of these deals after I warned him off – his view “I’ll just sue and get my money back if it does not work”. That is an undependable costly strategy.

Part IV OTHER IRS BENEFIT PLAN ISSUES OF CONCERN IN 2007-2008

A. 409A Compliance.

This is a lengthy topic – relates to Non Qualified Deferred Compensation Plans. Discussed in past Tax Institutes – please keep in mind that all arrangements that defer compensation must comply with IRC § 409A to avert immediate taxation and a 20% penalty.

Here is a recent blurb from the IRS:

"Treasury Deputy Benefits Tax Counsel Helen H. Morrison told attendees at a recent Webinar that the Internal Revenue Service (IRS) will waive the requirements for Code Y reporting in 2008 of amounts deferred under 409A for nonqualified deferred compensation plans (NQDC). Morrison also said Treasury expects to soon the issue proposed regulations on how to calculate amounts that would be included in income due to a failure to meet 409A requirements. The proposed regulations will also "serve as a foundation for providing guidance as to what would be reported for complaint plans," using Code Y on Form W-2, she said. If a plan fails to comply with the regulations, the employer must report amounts includible in income on Form W-2 in Box 12, using Code Z. In the case of plan failure, the employee would be subject to immediate income inclusion and penalties, including an additional 20% tax and, in certain cases, an interest tax. Addressing other year-end issues, Morrison said all plan documents and final elections as to time and form of payment must be completed and reduced to writing by the end of this year (2008). Regarding plan documents, Morrison said Section 409A imposes few requirements, "but they are important," including:

- The plan document need not be a single document;
- The plan document must address time and form of payment and when payment will be made in accordance with the six permissible payment times;
- Elections must be made in accordance with the regulations and in writing; and
- Public companies must provide for a six-month delay in payment in connection with a separation from service."

B. Converting an IRA Annuity to a Roth IRA

The IRS issued final regulations effective July 29, 2008 about conversions of IRA Annuity Contracts to a Roth IRA. (Reg § 1.408A-4)

Note – Apparently clever practitioners were attempting to convert IRA Annuity Contracts under a method that subtracts the surrender charges (usually artificially pumped up) from the value of the annuity.

The Regulations use approaches that generally ignore surrender changes (unless the annuity is irrevocably surrendered for cash before the conversion). The FMV calculation generally is the "cost of a comparable contract." If there is no "comparable contract," then the interpolated terminal reserve is used.

The new rules apply on or after August 19, 2005, although until December 31, 2008, the rules of temporary regulation §1.408A-4T (as it appeared on April 1, 2008) may be used.

C. Eligibility Screw-ups

The presenter has seen several situations where initial new Qualified Plans impose eligibility requirements that the owners do not meet! Do not make this mistake! The IRS takes this seriously.

Examples (real):

1. Plan created in December 2003. Business began late July 2002. One year eligibility with January 1 and July 1 "entry dates." $200,000 deduction taken for 2003. IRS audited. 2003 deduction disallowed. Owners did not have one year prior to July 1, 2003 – thus were not eligible for the Plan in 2003.
2. 401(k) Plan created in summer 2008 for a new business that began in April 2008. One year eligibility. Plan also said anyone employed on Plan "effective date" (January 1, 2008) was eligible immediately. Problem? No one employed on January 1, 2008. I spotted this upon takeover and am fixing it by amendment – its still within first plan year.

D. Predicable Market Crash Employee Disputes

Happens every time market spikes or crashes – in my 32 year experience. Defined Contribution Plan with "pooled accounts" (not most 401(k) plans) usually uses last day of Plan Year for valuations.

Example:

> Fully market invested Profit Sharing Plan loses 40% from December 31, 2007 until now. I have $100,000 account balance on December 31, 2007 and quit in October 2008. Plan says valuation is last day of prior plan year. Do I get $60,000? Or $100,000? Can Plan postpone paying me until January 2009 to revalue? Does the Plan allow the Trustee to do an interim valuation?

Comment: All good questions. Check your Plan language carefully and seek advice if uncertain. A Defined Contribution Plan with pooled accounts is a "zero-sum" game. Overpay one person and someone else gets shafted. Every crash I have seen results in cases (I have one going right now) where someone is attempting to get paid the pre-crash account value. Pay them at your peril – as you have duties to everyone in the Plan! Review the Plan documents and seek advice if uncertain.

E. Giving Participants Investment Advice? Be Careful!

Urban Myth! – You are required to provide investment advice to your 401(k) participants. Wrong!

"The PPA cleared away some of the ambiguity surrounding the provision of advice. A plan sponsor can install an "eligible investment advice arrangement" (EIAA) for the benefit of the plan's participants. Both the plan fiduciary and the investment adviser must meet a series of conditions. The U.S. Department of Labor believes that advice can still be provided to plan participants under any of the models used prior to the enactment of the PPA. Plan sponsors need to take a very close look at the advice regulations. A EIAA must be authorized by a plan fiduciary (other than the fiduciary adviser), there will be the usual fiduciary obligation to prudently select and monitor the adviser. Plan sponsors will be off the hook for the result of any specific advice given and followed, they will have to be aware of the performance of the fiduciary adviser and be ready to remove the adviser if appropriate. They will also need to particularly mindful of the revenue sharing that is paid on the assets for which the advice is given. Some commentators believe these new rules could open up a new avenue of litigation against plan sponsors and advisers. The Department of Labor and the ERISA plaintiffs' bar has been relatively inactive in the past in bringing suits based on investment advice, but the new rules will undoubtedly create myriad traps for unwary sponsors and advisers. Careful analysis and planning will be required to avoid converting the best intentions of employers into another potential vehicle for ERISA litigation.

Those seriously interested in this topic should review DoL Proposed Regulations issued in August 2008. The Regulations describe an "Eligible Investment Advice Arrangement." My view is that – for most employers I know – the new rules will both be (a) more trouble then they are worth and (b) the cost to provide the services will be prohibitive. Best for most plans to let the participants browse the investment firm's website and let them, on their own, use generic resources provided by the investment firm.

F. Continuing Reminder About Small Plan Bonding/Accountant Audit Rules

U.S. Department of Labor Regulations §2520.140-46 (10-19-2000) - The "small plan" (under 100 participants) CPA audit exception is not automatic.

Prior Regs exempted all small plans from audit requirements. Regs, effective for Plan Years beginning after April 17, 2001, are not so generous. Exemption for small plans applies only if:

(1) 95% of plan assets are "qualifying plan assets" - or

(2) Any person handling non-qualified assets is bonded. The amount of the bond must equal the face value of non-qualifying assets."

"Qualifying Plan Assets" are:

1. Qualifying employer securities under ERISA §407(d)(5)
2. Loans to Participants that meet ERISA §408(b)(1) (adequately secured, bear interest)
3. Assets held by bank or similar institution
4. Assets held by insurance company
5. Assets held by registered broker dealer
6. Assets held by any organization authorized to act as an IRA custodian
7. Mutual funds
8. Investment and Annuity Contracts issued by an insurance company
9. Individual Directed Accounts held by a regulated financial institution.

Not QPAs (unless held in a bank trusteed earmarked account) are limited partnerships, real estate, trust deeds, loans to nonparticipants, etc.

<u>What is the problem</u>? Bond should be in place the entire plan year to gain the exemption. All 2002 and after Plan Years are affected. We have found only one surety company willing to issue 100% bonds for a nominal fee (example $400 or so for $300,000 of coverage for 3 years) and the maximum bond limit is $500,000. Bonds can - for an added fee - be retroactive to the beginning of the affected Plan Year.

<u>Example</u>–Profit Sharing Plan has $3,000,000 and 20 participants. No bank trustee. Individual Earmarked Accounts have $1,000,000 in real estate, limited partnerships and trust deeds. Plan year begins January 1, 2008. Plan must obtain at least a $1,000,000 bond as of January 1, 2008, or secure a CPA audit for the plan year ending December 31, 2008. Source of bonds over $500,000 is limited and expensive (we saw quotes for $5.00 per $1,000 of coverage).

<u>Alternatives</u>? If bond is unavailable or too costly - consider alternative of terminating plan (technically not available to get out of audit rule after effective date and prior to termination) and rolling offending "non-qualified assets" to single participant frozen Money Purchase Pension Plans, or perhaps an IRA (if you can find a suitable custodian and creditor protection is of less concern), or taking other appropriate (make sure you are in compliance with other qualification rules) action to sell or distribute Non-QPAs from the plan. Or arrange for a bank trustee.

G. <u>Recent IRS Blast on “ROBS” (Rollover as Business Start-Ups)</u>

Those of you who have browsed franchise marketing sites probably have seen ads for rolling over your IRA or qualified plan funds to a different type of plan – whereby the funds are invested through the new plan into a franchise opportunity – thereby using the funds to leverage into a business opportunity.

The IRS Director of Employee Plans issued Guidelines on October 1, 2008 relating to ROBS.

Note – I have previously worked on several ROBS over the years – in both ESOP and Profit Sharing Plan format – in formats that do not – in my view – fall exactly within the IRS concerns. Have not done one recently but will be more cautious in the future. ROBS usually involve a "C" corporation and a Profit Sharing Plan with special language allowing purchase of C corporation stock. The IRS has identified 9 promoters of using IRA funds in this manner to buy franchises. The October 2008 Guidelines Memo indicates the IRS has examined a number of these Plans and found "significant disqualifying operational defects" in most. The Memo points out deficiencies in four primary areas – 1. The only one who gets stock is the original entrepreneurs' account, 2. deficiencies in the initial and annual stock valuations, 3. "prohibited transactions" in using plan funds to pay fees to the promoter of the concept, and 4. is the plan "permanent."

The Memo concludes ROBS transactions may violate law in several regards. The primary violation claimed is the "exclusive benefit" rule.

I am not sure where a copy of the Memo is available on the Web. I will post it on my firm's website as an Exhibit to this Outline.

H. Benefit Impacts of HEART Act of 2008

a. The law allows a Reservist called up for active duty for at least 180 days to withdraw health flexible benefit spending account funds without the health flexible spending account or cafeteria plan losing its status as such.
b. Penalty-free withdrawals from retirement plans are okay for individuals called to active duty. Generally, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59 ½ is subject to a 10-percent early withdrawal tax. In 2006, an exception to this 10-percent early withdrawal tax was provided for qualified reservists called to active duty for at least 179 days. This exception expired on December 31, 2007. The HEART Act made this exception permanent.

I. U.S. Supreme Court QDRO/Beneficiary Designation Pending Case

Kennedy vs. DuPont Savings Plan Administrator is a case being heard before the Supreme Court in November 2008.

Facts – Texas State Divorce Decree (Order) provided for the non-participant spouse to waiver her community property share of benefits. The participant later died and – lo and behold – ex-Mrs. Kennedy was still named as sole beneficiary of Mr. Kennedy's benefits. DuPont distributed $402,000 to the former spouse and Mr. Kennedy's estate sued. The District Court ruled for the estate but the Federal Fifth Circuit Appeals Court reversed and ruled for ex-Mrs. Kennedy.

The issue is "does the divorce decree trump the plan documents that state the beneficiary form controls?"

Note – DuPont was aware of the estate's claim before the funds were distributed.

The ruling on this case should be issued within a few months.

What does this case tell you? Always make sure to correctly change the beneficiary of the Plan if you divorce and your spouse has waived his/her community share of the Plan. As a backstop it appears "best practice" also might entail a proper QDRO (Qualified Domestic Relations Order) filed with the Court and approved by the Plan under which the spouse formally waives benefits.

J. Defined Benefit Plan Lump Sum Certification October 1, 2008 Deadline

For Defined Benefit Pension Plans, calendar year plans had until September 30, 2008 to obtain an actuary's certification of the plans "adjusted funded target percentage" (AFTAP). No certification? AFTAP is presumed to be less than 60%. AFTAP less than 60% results in Internal Revenue Code § 436 limits on accrual of benefits and restrictions on payment of benefits (including lump sums).

Note – Highly technical stuff – see your actuary.

K. Transfer of Plans?

The IRS issued Revenue Ruling 2008-45 to attempt to halt "sales of Pension Plans." This market relates to "sale" of an over funded Defined Benefit Plan to an unrelated party so that the seller can realize a benefit from the over funding. Current law imposes a 50% excise tax on "reversions to the plan sponsor – which combined with income tax – almost confiscates the money.

Comment – Is any Defined Benefit Plan in America over funded after the last two months? I know one plan that bet right and became significantly over funded in 2008. An anomaly for sure!

The Rev. Rule states unequivocally that current law prohibits the transfer of a tax-qualified plan from an employer to an unrelated taxpayer unless connected with transfer of "significant business assets, operations or employees." It is claimed the transfer violates ERISA's "exclusive benefit rule." Watch for legislation and further rulings – be careful and get counsel if you are thinking of such a transaction.

Part V **<u>HIGHLIGHTS OF SOME NEWER PENSION CONCEPTS:</u>**

A. <u>Refresher on Concept of Defined Benefit Plan Straddle</u>

We find many CPAs who believe a Defined Benefit Plan is inflexible, a straightjacket of sorts, cannot the amended to reduce contributions and has no flexibility. Flexibility is particularly important with market volatility and prospective company inability to fund due to reversals in the economy. Here is a possible counterpoint to that.

Small business with cyclical but significant income sets up a Defined Benefit Plan – primarily to benefit the 55 year old owner. Facts:

Calendar year S corporation
Defined Benefit Plan Year of December 1 to November 30

<u>Year One 2008</u>

Corporation deducts $100,000 on a "beginning year valuation – permissible under IRC §404 regulations – for 2008-2009 Plan Year.

<u>Year Two 2009</u>

Same as above for 2009-2010 Plan Year.

<u>Year Three 2010</u>

Business is "bumpy" = little profit for 2010 but 2011 looks terrific. CPA requests IRS to switch to "end of year valuation" method (choices are 1. Beginning 2. End 3. Hybrid). Contribution for 2010 is zero.

<u>Year Four – 2011</u>

Contribution of $110,000 (assume) is made for 2010-2011 Plan Year – due date is August 15, 2012 (assuming 2011 1120 is on extension until September 15, 2012). Why not September? 8½ months funding period deadline after 11-30-2011 is 8-15-2012. Employer seeks more flexibility again – thus amends DB Plan before February 2012 (so no employee has accrued a benefit to reduce benefit formula) – so that contribution for 2011-2012 Plan Year is within expected profit levels. Or freezes benefits for one year and reactivates benefits again on 12-1-2012, so as to get back to paying contributions in ADVANCE, rather than in arrears.

There are many variations on this, bur the game plan is to do this: 1. Contribute in advance before benefits accrue – if at all possible, and 2. Minimize accruals from occurring <u>before</u> the business has identified the source of $ to pay for them.

This “straddle” method reduces the need for Plan benefit formula amendments, (the IRS frowns on frequent amendments to a benefit formula – no frequent fixed standard – once every 3 years usually creates few issues) and even more importantly, reduces accruals of employees in situations where benefits have accrued, but funds to pay for them are non-existent. You are usually ahead in funding with a straddle. We have found a straddle invaluable when two co-owners are in a DB Plan together. This helps reduce chance one will leave at a time when his/her accrued benefits are not fully funded-thereby creating a potential dispute as to “who pays?”

B. Defined Benefit Plan Funding Impact of Pension Protection Act of 2006.

Comment – The PPA 2006 is impacting the amounts you can fund for a new Defined Benefit Plan beginning in 2008. See an except from a recent memo from a local actuary to me:

“There are now 2 categories for a first year plan:

1. If you grant service for benefits only from date of Plan inception, it will be approximately 65% -70% of pay for a 50 year old and 85% - 90% of pay for a 55 year old.

2. If you grant past service for benefits, it will be approximately 80% - 85% of pay for a 50 year old and 100% - 110% of pay for a 55 year old.

See below * for a reason a first year plan doesn’t get as much as before.

* There is a “150% of funding target” rule on max deductions for a DB plan for plan years beginning in 2008 or later. But the 150% only applies to the beginning of year accrued benefit. The benefit accrual during the year is applied at 100%. So, a first year plan with no past service benefits gets to deduct 100% of the so-called “lump sum accrual” for the year based on IRS interest and mortality rates. (3 – tiered interest rates from corporate bond yield curve, approximately 6% per year for 1/1/08 when blended, and RP 2000 mortality table, projected to 2008).”

C. Recent Example of Impact of PPA

* Owner (no employees) makes $600,000+ as a sole proprietor. Age 56 on 12-31-2008.

Defined Benefit Plan

Maximum Contributions for 1st year 2008 Defined Benefit Plan:

With 2007 Past Service $241,819

With no pre-2008 Service $187,160

Adding a 401(k) Plan will add the following:

$15,500	Deferral
$5,000	Catch Up
$13,200	**6% of pay allowable deduction under IRC §404**
$33,700	

Total is $275,519 (with no insurance or non standard assets). This is not a 412(i) Plan.

D. Cash Balance Plans

The Pension Protection Act of 2006 (PPA Section 701) affirmed the viability of a "Cash Balance" Defined Benefit Plan that meets specific requirements (including 100% vesting with 3 Years of Service). Here is a recent Plan formula we sent to the IRS for approval (with names changed):

"Employer Credits: Employer Credits shall be determined on a "Group" basis as follows:

A. Group One: Comprised of Robert K. Butterfield. An amount equal to: $143,500 for each Determination Period.

B. Group Two: Comprised Marc S. Schechter. An amount equal to $143,500 for each Determination Period

C. Group Three: Comprised of all Participants other than those in Groups One or Two: An amount equal to 1.5%* (see below) of Compensation during the Determination Period."

* The 1.5% for non-owners was supplemented by 6% of compensation in a companion 401(k) Plan – 7.5% total. The "top heavy" minimum benefit is provided in the 401(k) Plan.

What is a cash balance plan?

A cash balance plan is a "defined benefit plan" but is considered a "hybrid". Investment risk is borne by the plan sponsor. As with defined contribution designs, plan benefits are expressed in the terms of a fictional account balance, and are usually paid as cash balances upon termination of employment. In a Cash Balance Plans, an employee's fictional account balance grows by a defined rate of interest and annual employer contribution.

PART VI INCREASES IN COLA LIMITS FOR 2009

	2008 Limit	2009 Limit
401(k) Deferrals	$15,500	$16,500
401(k), etc. Catch up	$5,000	$5,500
415 Defined Contribution Limit (based on year Plan Year begins)	$46,000	$49,000
Defined Benefit Plan Annual Benefit Limit (based on year Plan Year ends and age 62+)	$185,000	$195,000
Maximum "Countable Compensation" for Qualified Plans	$230,000	$245,000
Officer Compensation Threshold for Key Employee	$150,000	$160,000
Highly Compensated Employee (based on year in which the preceding Plan Year begins)	$105,000 ($100,000 in 2007)	$110,000
SIMPLE IRA Limits		
Deferral	$10,500	$11,500
Post-50 Catch up	$2,500	$2,500
Social Security Taxable Wage Base (for integrated Plan formulas)	$102,000	$106,800
IRA Contributions	$5,000	$5,000
Added Post-50 Catch up	$1,000	$1,000

Part VII **CONTRIBUTIONS TO IRAs**

● **Deductible?**
Are you or your spouse an "active participant" in the qualified plan?

Tax Year	**Single, Active Participant**	**MFJ, Active Participant**	**MFS, Active Participant**	**Married Jointly Active But Spouse not active** (non active spouse can deduct if AGI below $156,000)
	Low End to High End Phase Out	Low End to High End Phase Out	Low End to High End Phase Out	
2008	**$53,000-63,000**	**85,000-105,000**	**0-10,000**	**159,000 – 169,000 phase out**
2009	**$55,000-65,000**	**89,000-109,000**	**0-10,000**	**166,000-176,000**

Saver's Credit

● **Saver's Credit for Lower Income – 2008 limits**
Saver's tax credit rates for up to $2,000 of contributions based on AGI are as follows:

Joint Filters	**Head of Household**	**All Other Filers**	**Credit Rate**
$0-$32,000	$0-$24,000	$0-$16,000	50%
$32,001-$34,500	$24,501-$25,875	$16,001-$17,250	20%
$34,501-$52,000	$25,876-$39,750	$17,251-$26,500	10%
Over $53,000	Over $39,750	Over $26,500	0%

SIMPLE Retirement Account

● **Example – Corporate Owner making $300,000 W-2**
His/her maximum 2008 and 2009 SIMPLE is:

	2008	2009
1. Deferral	$10,500	$11,500
2. Catch up Deferral	$2,500	$2,500
3. Employer Match	$9,000	$9,000
Total	**$22,000**	**$23,000**

Roth IRAs

● **Eligibility – 2008 and 2009**

Contribution – Couples filing jointly $159,000 - $169,000 phase out ($166,000 - 176,000 for 2009), singles - $101,000 – 116,000 phase out ($105,000 - 120,000 for 2009).

Conversions – Until 2010 - $100,000 (if not married filing separately – if so then its $0) AGI (without regard to RMDs). 2010 – unlimited – but why would someone in high bracket want to do that?

Pension Protection Act of 2006
Extended by Emergency Economic Stabilization Act of 2008

● PPA 2006 allowed up to $100,000 per year directly to a 501(c)(3) qualifying charity from an IRA (only IRAs-not qualified plans). The recent Emergency Economic Stabilization Act of 2008 extended it to 2008 and 2009.

● No reportable income
● No impact on AMT
● No AGI limits
● Non-itemizers can use it to make any IRA transfer to a charity.
● Distribution does count for post 70½ required minimums.
● 2% "Haircut" rule avoided.
● IR-2006-135. IRS reminded military veterans that tax-free combat pay can count in determining eligibility for an IRA. They have until 5-28-2009 to retroactively make contributions for 2004 or 2005.

PART VIII **<u>CREDITOR PROTECTION UPDATE</u>**

The Amended Bankruptcy Act went into effect October 17, 2005. 11 U.S.C § 522.

United States Bankruptcy law provides the following:

1. Pension Plans subject to ERISA - Exempt under ERISA, Exempt in Bankruptcy under Bankruptcy law.

2. Corporate Plans - Exempt under California law (and Federal if ERISA covers), Exempt in Bankruptcy context, too.

3. Sole Proprietor Plans with no employees, SEPs, SIMPLE IRAs - not exempt under CA except to extent judge allows under a financial needs test - Not Exempt under ERISA, Exempt in Bankruptcy under recent Bankruptcy law.

4. IRAs (see below)

- Not exempt under ERISA

- Not exempt under California law except to extent a judge allows under a financial needs test.

- Exempt in Bankruptcy context if from a rollover of qualified plan funds, or from SIMPLE or SEP contributions and exempt up to $1,000,000 for other IRA funds.

<u>Comment</u> - The Bankruptcy protection applies only in Bankruptcy. If one prefers not to file for Bankruptcy, or does not qualify for Bankruptcy under the new "earnings" test, the old regime still applies! Thus, IRAs, SEPs, SIMPLE IRAs and owner only "Keogh" Plans still have less protection than a corporate or ERISA qualified plan in California!!

<u>Recent U.S. Supreme Court case</u>: The U.S. Supreme Court ruled early in April 2005 that IRAs were exempt under Federal law from attachment by creditors, but - <u>caveat</u> - only to the extent deemed to be “reasonably necessary” to support the debtor. An Arkansas couple in bankruptcy was allowed to keep a $55,000 IRA. This case applied to a Bankruptcy filed before the new Bankruptcy law went into effect.

<u>Comment</u> - This parallels California law relative to creditor protection of IRAs. Nothing new, and it is superceded anyway by the new 2005 Bankruptcy law for newer Bankruptcy filings.

PART IX AMENDMENT CYCLES

A. EGTRRA Amendment Cycles

All Defined Contribution Plans and Defined Benefit Plans need amending for EGTRRA and other laws and regulations under a 5 year cycle - (cycles began to end in 2007! See below:

Over the past six years the Internal Revenue Service and the Department of Labor have issued regulations that affect a Qualified Plan. Laws enacted in 2001 (EGTRRA) also mandate a series of amendments to bring the Plan into compliance. The IRS implemented a staggered deadline to bring qualified plans into compliance based upon the **last digit of the plan sponsor's federal employer identification number (EIN).**

All qualified plans must be amended to comply with the new regulations to maintain the plans' tax-qualified status. The compliance periods are as follows:

(See the last paragraph below for extended periods for Volume Submitter Plans)

Last Digit of Plan Sponsor's EIN	Cycle	EGTRRA Remedial Amendment Period Ends
1 or 6	A	January 31, 2007
2 or 7	B	January 31, 2008
3 or 8	C	January 31, 2009
4 or 9	D	January 31, 2010
5 or 0	E	January 31, 2011

The amendment to the Plan is mandatory. Plans previously using Volume Submitter or Prototype documents or prior individually designed plans that adopted a special IRS Certification prior to the end of the applicable cycle have extensions of the deadlines. The extension generally is a year or more after the approval of the basic Volume Submitter document by the IRS - which means plans with EINs ending in 1, 2, 6 and 7 with Volume Submitter or Prototype will most likely not need to be amended until after the due date shown above.

Plans which fell under Cycle A or Cycle B (last digit of plan sponsor EIN ending in 1 or 6) which were not already on a Volume Submitter or Prototype Document needed to adopt a Certification of Intent to amend on an IRS approved Volume Submitter or Prototype plan document **by January 31, 2007 (or 2008).** This Certification on IRS Form 8905 significantly extends the compliance period.

Note - ESOPs, Non prototypes or Non Volume Submitter documents need to pay close attention to the above to avert missing a deadline to amend for EGTRRA, etc. And individually designed plans with a January 31, 2007 or 2008 deadline needed to sign Form 8905 on or before January 31, 2007 or 2008 if they were planning to convert to a Volume Submitter or Prototype format.

Note - The IRS issued all Volume Submitter and Prototype Determination Letters on March 31, 2008. This means the plans falling under these letters generally have until April 30, 2010 to be restated for EGTRRA.

B. Interim Amendments

All qualified plans also must be amended for several other items for 2008 (this discussion does not refer to amendments required in prior years - this is not a hardcore pension seminar):

1. Pension Protection Act of 2006. Amendments are required in 2008 if the Plan is terminating. Otherwise, amendments not required until the Plan Year beginning in 2009.

2. April 2007 Final Regulations under Internal Revenue Code Section 415 (benefit limits and compensation definitions for benefit limits). These technical amendments apply to Limitation Years beginning on or after July 1, 2007. The due date is not extended by the extended dates for later “cycles” or the extended due dates for Volume Submitter/Prototype Plans. The amendment must be adopted by the applicable date below:

a. End of limitation year beginning on or after July 1, 2007 if limitation year is not the same as the Employer’s Tax Year.

b. Due date of Employer’s Tax Return for years beginning on or after July 1, 2007 if the Employer’s Tax Year and the Limitation Year coincide.

Examples:

*Calendar Year Plan - Calendar Year Employer - due date is March 15, 2009 if it is a corporation - could be extended to September 15, 2009.

*Calendar Year Employer - Defined Benefit Plan Year begins December 1, 2007. Amendment must be adopted on or before November 30, 2008.