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Treasury and IRS Issue Valuation Guidance for Life Insurance, 412(i) Plans and Pension Rescue

On Friday, February 13, 2004, the Treasury and IRS released much anticipated proposed regulations regarding the valuation of life insurance contracts for income tax purposes. The regulations also set forth the tax consequences of undervaluing a policy in a transaction involving the transfer of a life insurance contract. The regulations are aimed at perceived abuses with certain life insurance contracts and plan designs of some 412(i) plans and "pension rescue" arrangements.

Specifically, the regulations address the valuation of life insurance contracts when selling or transferring a policy from a qualified plan to a plan participant, sales or transfers of a policy from an employer to an employee, and certain transactions involving group term contracts under Section 79 of the Internal Revenue Code. A public hearing on the regulations is scheduled for June 9, 2004.

Brief Overview of the Valuation Issue

Over the past several years aggressive planners have sought to exploit the uncertainty regarding the proper valuation of life insurance to achieve dubious tax benefits. Two areas that have caught the IRS's attention are the valuation games being played with certain 412(i) and pension rescue plans. In the 412(i) arena, the IRS is particularly concerned about the use of policies that have very low cash surrender values during the funding years when the policies are held by a 412(i) plan but later "spring" to life when purchased or distributed from the plan, or once outside the plan these low value policies are exchanged for policies that have high cash values.

The IRS is concerned that these tax-deductible plans are also being used to fund non-qualified deferred compensation for highly compensated employees at little or no income tax cost to such employees. The same concern is involved with pension rescue type plans. Finally, the IRS is concerned about potentially abusive group term plans that seek to take advantage of Section 79 valuation rules to provide permanent benefits to highly compensated employees at the expense of rank and file participants.

Policy Valuation Under the Proposed Regulations

The proposed regulations essentially adopt a fair market approach using the willing buyer/willing seller standard for policy valuation. If policy design or contractual provisions distort cash surrender value or interpolated terminal reserve (ITR), such values will no longer be respected as proxies for fair market value. Fair market value must be determined by considering policy cash value (without regard to surrender charges) and all other rights under the insurance contract (including any supplemental agreements) whether such rights are or are not guaranteed. Going forward, if a taxpayer fails to adequately determine fair market value, the taxpayer will suffer adverse income tax consequences as a result.

It is also important (and frustrating) to note that the proposed regulations do not provide a process or formula for determining fair market value. Rather, the preamble to the regulations recites when ITR and cash value CANNOT be used as a proxy for fair market value. The proposed regulations are meant as a death knell to abusive tax planning using valuation games and the qualified plan rules. In addition, the proposed regulations simply require the same valuation rules of Sections 79 and 83, so that all valuation is in conformity with the IRS's latest round of attack on abusive tax planning.

Effective Date of the Regulations

The proposed regulations should not be viewed as the IRS's attempt to put an end to all 412(i) plans. The regulations are generally effective as of February 13, 2004. However, the provision of the regulations that would subject the difference between the amount that a qualified plan participant pays for his policy and the actual fair market value of the policy will be effective for transfers (i.e., sales or exchanges) that occur on or after the date of publication of final regulations in the Federal Register (not likely to happen until the second half of 2004).

Revenue Procedure and Revenue Rulings

In addition to the regulations, the IRS also issued a Revenue Procedure and two Revenue Rulings on issues relating to the valuation of life insurance and retirement plans. Revenue Procedure 2004-16 provides interim guidance for when a contract's cash surrender value (without reduction for surrender charges) may be treated as the contract's fair market value for purposes of the qualified plan rules and Sections 79 and 83 of the Code.

<u>Revenue Ruling 2004-20</u> - Excess Benefits under 412(i) Plans

This Revenue Ruling addresses the following two issues: Can a qualified plan be a 412(i) plan if the benefits exceed the amount provided to the employee's beneficiaries (with the excess reverting to the plan)? Can an employer claim an income tax deduction for excess life insurance coverage?

Section 412(i)(3) requires benefits provided under a 412(i) plan to be equal to the benefits provided under each life insurance contract at normal retirement age under the plan. In addition, the life insurance company issuing the contracts must guarantee the benefits for each plan participant to the extent that premiums have been paid. The provisions of Section 404 and its regulations determine the limits for deductibility, which are generally based on the amounts determined under Section 412 for the applicable plan year. Section 1.404(a)-3(b) provides that the limitations for pension and annuity plans shall not exceed costs based on reasonable assumptions for the funding method and other pertinent factors.

The Revenue Ruling holds that a qualified plan cannot be a Section 412(i) plan if it has life insurance and annuity contracts that provide benefits at normal retirement age in excess of the participants benefits under the plan. In addition, employer contributions under a qualified plan that provides excess benefits will not be fully deductible the year that they are made, but they may be carried over and deductible in future years if other contributions to the plan are less than the maximum amount deductible under the limits of Section 404. Arrangements which provide excess benefits will be treated as "listed transactions", and may also be subject to disclosure, tax shelter registration and list maintenance requirements of the Internal Revenue Code.

<u>Revenue Ruling 2004-21</u> - Discrimination in Favor of Highly Compensated Employees

This Revenue Ruling reviews whether qualified plans satisfy the nondiscrimination rules of Section 401(a)(4) if the plan allows highly compensated employees to purchase life insurance policies from the plan at cash surrender value without providing equal rights to purchase a policy to nonhighly compensated employees.

The Ruling notes that a plan can satisfy the requirements of Section 401 only if all of the benefits, rights and features of the plan are provided in a nondiscriminatory manner to all participants. Section 401 has both a current availability requirement for rights, benefits and features as well as an effective availability requirement. Rights and features of the plan can include availability of a particular class or type of investment such as employer securities, or differences in insurance contracts that may be purchased from a qualified plan.

The Revenue Ruling holds that qualified plan does not satisfy the nondiscrimination requirements of Section 401 if it allows highly compensated employees to purchase life insurance contracts prior to distribution of retirement benefits and does not offer purchase rights under the plan to nonhighly compensated employees that are of equal or greater value than the purchase rights of highly compensated employees.

Bush Releases Proposed Fiscal Year 2005 Budget

On February 2, 2004, President Bush sent Congress a $2.4 trillion budget for fiscal year 2005 that he said reflected his national priorities - tax cuts, homeland security and generating long-term economic growth. The budget, if passed, would result in record deficits for the federal government. The proposed budget includes some familiar provisions from the Bush Administration budgets of the last few years:

- **An extension of some of the 2001 and 2003 tax cuts through 2010** - The budget proposes to extend tax cuts such as changes in the child tax credit, the marriage penalty and the 10% income tax bracket for individuals. The budget proposal would extend these provisions through 2010, rather than returning to the original provisions in 2005 from EGTRRA (the Economic Growth and Tax Relief Reconciliation Act of 2001).

- **Make some of the 2001 and 2003 tax cuts permanent** - Additional tax cuts made in 2001 and 2003 are scheduled to "sunset", or expire, in 2010, unless they are extended by further legislation. The President's budget proposal seeks to extend tax cuts in the dividend tax rate, the capital gains tax rate, expensing for small businesses, as well as repeal of the estate and generation-skipping transfer taxes. Since these tax cuts are the most expensive part of the President's budget, this proposal will likely result in a contentious debate in Congress.

- **Savings/Retirement Accounts** - The President's plan reintroduces the proposed creation of three new savings vehicles - Lifetime Savings Accounts (LSAs), Retirement Savings Accounts (RSAs) and Employer Retirement Savings Accounts (ERSAs). LSAs and RSAs, which could be used for a variety of reasons, would allow for annual contributions to a personal savings account of up to $5,000 with tax-deferred growth and tax-free withdrawals. ERSAs would consolidate 401(k) plans, 403(b) plans, governmental 457(b) plans, SARSEPs and SIMPLE IRAs into a single retirement account that could be sponsored by any employer. The maximum total annual contribution to ERSAs would be the lesser of 100% of compensation or $41,000.

  The budget also includes the proposal of a new savings initiative for low-income individuals called Individual Development Accounts (IDAs). IDAs would provide full matching contributions for up to $500 per year. Sponsoring financial institutions would receive a tax credit for their matching contributions to IDAs.

- **Charitable Giving Incentives** -The budget has a provision that would extend the income tax charitable deduction to taxpayers who do not itemize their deductions (up to a $250 deduction for single taxpayers and $500 for married couples). Another familiar proposal is tax-free withdrawals from IRAs for charitable contributions. Taxpayers could exclude from gross income distributions made after age 65 from a traditional or Roth IRA directly to a charity. However, unlike the CARE Act, the budget proposal would not allow the income exclusion for gifts from IRAs to a split-interest entity such as a charitable remainder trust, a charitable gift annuity or a pooled income fund. The charitable giving incentives carry a price tag of approximately $18.5 billion over the next ten years.

Republicans in Congress generally support the tax cuts and the defense spending in the President's budget. Although some Democrats in Congress have called for a rollback of the 2001 and 2003 tax cuts, it is an election year so it is unlikely that they will make such a proposal. However, it will be difficult to get many of the budget proposals passed, particularly in the Senate, due to the proposals for large spending and looming federal budget deficit.

The budget does not include a fix for a tax glitch created by the Alternative Minimum Tax (AMT). Although the AMT was originally targeted at high-income taxpayers, it has not been indexed for inflation and has been affecting a greater number of middle class taxpayers in recent years. Estimates for fixing the AMT problem have run as high as $500 billion. Also missing from the proposed budget was funding for certain projects favored by President Bush such as missile defense, an expanded space program, and the partial privatization of Social Security. For a more detailed description of the Presidents budget proposal, see the February 10, 2004 Special Edition of *Central Intelligence*.

Senate Discussion of Estate Tax Reform, Repeal

Senator Nickles (R-OK), Chairman of the Senate Budget Committee, is reporterly considering several different approaches to further estate tax repeal or reform. Possible approaches include starting estate tax repeal in 2009, or increasing the estate tax exemption and reducing the rates. Senator Charles Grassley (R-IA), Chairman of the Senate Financing Committee, has also recently spoken on the topic of estate tax and has indicated his preference for estate tax reform, by increasing the exemption and reducing the rates. However, due to budget restraints and looming deficits, it is not likely that the estate tax proposals will make much progress this year.

Senate Requires 60 Vote Supermajority for Tax Cuts

On March 10, 2004, the Senate voted 51-48 to require a 60-vote threshold for tax cuts over the next five years. This requirement would apply to all tax cut plans that are not paid for with other savings and would complicate plans to extend tax cuts passed in 2001 and 2003. Although this measure remains to be passed by the House and signed by the White House in order to become law, it was a setback for the White House and Republican leaders. Four Republicans in the Senate voted for the measure, reflecting growing concern over record federal budget deficits, which are expected to approach $500 billion in 2004.

Senate Finance Committee Approves COLI Proposal

The Senate Finance Committee has approved the COLI proposal that was circulated by Committee Chairman Senator Grassley's staff. (For a full description of the Chairman's proposal, see the February 2, 2004 edition of *Central Intelligence*). The COLI proposal was an alternative to amendments proposed by Senator Jeff Bingaman (D-NM), and is supported by the life insurance industry as a more reasonable proposal that would address some of the recent concerns regarding COLI but also preserve its benefits. The modified COLI proposal has been incorporated into the National Employee Savings and Trust Equity Act of 2003 (known as NESTEG). The Committee also extended the effective date of the nonqualified deferred compensation provisions in the legislation to December 31, 2004 (from the date of enactment in the original proposal).

The Senate Finance Committee approved the provisions included in the Chairman's proposal on providing notice to employees of life insurance in advance of policy issuance and notification to the IRS regarding employee consents to life insurance. The committee defeated an amendment that would have required employers to notify the IRS of a breakdown of the size of the COLI policies held by the employer. Senator Bingaman introduced, but then withdrew, an amendment that would have prohibited an employer from retaliating against an employee for refusing to give consent to COLI coverage. Other committee members questioned the need for the proposed anti-retaliation provision.

CARE Bill Remains Stalled

Last year the House and Senate passed separate bills, known as the CARE Act, providing tax incentives to boost charitable donations. The main disagreement centered around the lack of offsets included in the House Bill; the Senate version has offsets in addition to the tax incentives. However, since last fall, there has been no additional resolution on that issue. The CARE Bill has recently been added to the Senate's extraterritorial income (ETI) exclusion repeal bill but without sufficient revenue-raisers to offset the tax incentives, the CARE Bill is still unlikely to make much progress.

Supreme Court Denies Cert in American Electric Power Case

The U.S. Supreme Court has recently announced that it will not review the decision of the Sixth Circuit Court of Appeals in American Electric Power v. US (6th Cir. 2003) (see the June 2003 edition of *Central Intelligence* for a description of the American Electric Power (AEP) case). The Sixth Circuit ruled that the leveraged COLI plan in the AEP case was a sham in substance and disallowed the interest deductions, which was consistent with the Third Circuit decision in the In Re CM Holdings Case (3rd Cir. 2002) and the Eleventh Circuit decision in Winn Dixie Stores v. Commissioner (11th Cir. 2001). However, in the recent case of Dow Chemical v. U.S. (Mich. 2003), the court ruled that the leveraged COLI plans had economic substance and did not violate the "4 out of 7" test under IRC Section 264. That case is now being appealed to the Sixth Circuit Court of Appeals, the same court that issued the AEP decision (see the July 2003 edition of *Central Intelligence* for a description of the Dow Chemical case).

Court Dismisses Wal-Mart Claim Against Insurers, Brokers over COLI Plan

The Delaware Chancery Court dismissed Wal-Mart's lawsuit against AIG and The Hartford life insurance companies, as well as several insurance brokers. Wal-Mart sued for damages to recover losses from a broad-based leveraged COLI life insurance plan sold in 1993. Not only did Wal-Mart not receive the expected tax benefits from the COLI plan, it is now also the target of numerous lawsuits from numerous employees and their estates. Wal-Mart estimates that its losses from the failed COLI plans, exclusive of disallowed tax deductions will exceed $150,000,000. However, the court ruled that the three-year statute of limitations had already tolled on Wal-Mart's claim and that the company should have known or become aware about the possible risks associated with leveraged COLI plans before the statute of limitations expired on September 3, 1999.

IRS Expanding Compensation Audits, Including Split Dollar

A senior IRS official speaking at a meeting of the American Bar Association Tax Section indicated that the IRS is expanding its auditing of executive compensation. In particular, the IRS will focus on eight issues: 1) split dollar life insurance arrangements; 2) loans to executives; 3) nonqualified deferred compensation; 4) golden parachutes; 5) equity compensation arrangements; 6) fringe benefits; 7) asset protection schemes; and 8) compliance with the $1 million deduction limit under IRC Section 162(m). These efforts and statements are consistent with comments made by Treasury Department officials on executive compensation in connection with the recent corporate scandals.

IRS Continues to Target Tax Shelters

Following the issuance of guidance on various issues related to tax shelters, the Treasury Department has announced a series of legislative proposals targeting tax shelters from President Bush's new budget. The proposals include IRS Compliance and Enforcement Proposals on many related issues, including the following areas: 1) penalties for taxpayers and promoters for nondisclosure of potentially abusive transactions; 2) uniform rules allowing for promoter registration and list-maintenance; 3) allowance of injunctive action against promoters who repeatedly disregard registration and list-maintenance requirements; and 4) increased penalties for false statements made to promote tax avoidance transactions.

IRS Targets Abusive Roth IRAs

Notice 2004-8

The IRS has started to attack a new form of abusive Roth IRA transaction involving two corporations. A taxpayer will typically own a pre-existing business and the Roth IRA will own "substantially all" of the shares of another corporation. The two corporations will do business with each other, but the goods, services and shares are not fairly valued in the transactions, and as a result, the value shifts disproportionately to the Roth owned corporation. Since the Roth IRA distributions are generally tax free, the tax advantage also gets shifted to the IRA account.

In Notice 2004-8, the IRS has indicated that this type of transaction is a "tax avoidance transaction" and will be treated as a "listed transaction" as of December 31, 2003. The organizers and managers of listed transactions must register the tax shelter with the IRS, must maintain a list of customers for IRS inspection and the taxpayer must attach a disclosure statement to his/her income tax return.

FLP Value Included in Taxpayer's Estate

Estate of Abraham v. Commissioner, T.C. Memo 2004-39

Facts: The taxpayer became mentally incompetent due to Alzheimer's disease in 1993, and the court appointed her two children as her guardians. The guardians petitioned the court to make gifts to reduce the expected estate tax liability and the court approved a gifting arrangement including the establishment of three family limited partnerships (FLPs), one for each of Ida's children and annual exclusion gifts of the FLP interests to Ida's family members. Ida, through her guardian and a corporation, was a general partner as well as a limited partner in the FLPs. A gift of 30% of one of the FLPs was given to one of Ida's children. Each guardian also bought a share in the FLPs.

Ida died in 1997. The IRS argued that the full value of two of the FLPs and 70% of one of the FLPs should be included in Ida's taxable estate. The IRS sought to disallow the discounted value of the FLP interests given by an appraiser.
Ruling: The Tax Court found in favor of the IRS, and included the value of the FLP interests in Ida's estate. The Tax Court found that even after the FLPs were established, Ida was receiving income from the FLPs until her death, and the guardians used the FLP income to pay for Ida's expenses. Under IRC Section 2036(a), the full date of death value of the FLPs was to be included in Ida's taxable estate.

Discussion: The Abraham case is a clear situation of "bad facts" and reinforces the principle, as seen in a line of recent cases, that FLPs must be created and managed carefully to avoid IRS scrutiny. Generally speaking, once a person is mentally incompetent, doing anything more than basic annual exclusion gifts is not advisable, and is likely to raise red flags for the IRS. This case is another victory for the government in an FLP case, following the recent Strangi, Kimbell, Harper, Thompson and Reichardt decisions.

In another development involving FLPs, the Fifth Circuit Court of Appeals is currently hearing an appeal in the Kimbell case, and questions from the panel of judges have indicated that some of the judges are concerned about valuation discounts for FLPs and LLCs, particularly for "deathbed FLPs." In Kimbell, the Federal District Court held that FLP interests should be included in the decedent's estate under Section 2036. We will keep you up to date on any further developments in these cases.

FLP Tax Court Case Allows Discounts, but Disregards Partnership

Estate of Lea K. Hillgren, T.C. Memo 2004-46

Facts: The Taxpayer, who had a history of mental health problems, created a California limited partnership 5 months before she committed suicide. She transferred seven properties to the partnership and she and her brother were the sole partners in the partnership. The properties were also subject to a Business Loan Agreement (BLA), under which the Taxpayer was the borrower and her brother extended her a $1 million line of credit. However, the partnership was not operated in a businesslike manner and the Taxpayer received distributions from the FLP to pay her living expenses.

Ruling: The Tax Court held that the value of the properties would be included in the Taxpayer's estate under IRC Section 2036, since the FLP assets were used to support the decedent and the entity was not respected. However, the Court did allow valuation discounts for estate tax purposes based on the restrictions in the BLA - 55% for one property and 35% to 40% for three others, plus 5% for lack of voting rights. Even though the partnership assets were included in the Taxpayer's estate, the fact that there was a valid business agreement meant that significant valuation discounts were accepted by the Court.

Appeals Court Rules that Will Trumps Beneficiary Designations

Liberty Life Co. v. Kennedy, F.2d (11th Cir. 2004)

Facts: Clint Kennedy, the insured, participated in his employer's executive life and personal accident program, which is a welfare benefit plan under ERISA ("the plan"). Kennedy got divorced in 1991, and then remarried in 1993, but failed to change the beneficiary designation in the plan from his prior wife to his new wife. However, prior to his death, he did execute a will that designated the new wife and his children as the plan beneficiaries. His ex-wife challenged the will, and argued that the beneficiary designation preempted the will.

Ruling: The Eleventh Circuit Court of Appeals ruled that the provisions of Clint's will trumped the beneficiary designation naming his prior wife as the plan beneficiary. In this case, the plan language allowed the participant to use an alternate form of beneficiary designation - and does not require the employee to use a specific designated form. As a result, the Court held that Clint's will was the controlling beneficiary designation.

IRS Allows Funding of Bypass Trust from Single Pool of Assets

As the estate tax exemption continues to rise (currently $1.5 million), estate planners are looking for new ways to fund credit shelter trusts - also known as bypass, or Family Trusts - and maximize the exemption for married couples. Traditionally, the best way to maximize the exemption is for both spouses to have separate assets in his or her name up to the exemption amount. However, some assets are not easy to divide, such as businesses, partnerships or retirement accounts. Some estate planners have used a joint revocable trust (see PLRs 200101021 and 200210051) - another option may be to have one spouse create a revocable living trust and fund it with one pool of assets, as described below.

PLR 200403094

Facts: A Husband and Wife are trying to maximize their estate tax exemptions in their estate plan, regardless of who dies first. The husband plans to establish a revocable living trust and fund it with the assets in his name. Upon his death, the trust assets will be divided into two shares - a marital trust for the benefit of his wife, and a bypass, or Family, trust for his exemption amount. Husband's trust also provides that if Wife dies before him, she has a general power of appointment over the trust assets to the extent of her remaining estate tax exemption amount, less the value of her estate. The wife plans to execute a will that exercises the power of appointment in favor of her estate, and then divides her estate between the exemption amount going to a Family Trust and the balance going to her husband.

Ruling: The IRS ruled favorably on all four requests made by the taxpayers:

1) If Wife predeceases Husband and exercises her general power of appointment, husband will be treated as making a gift to Wife for the assets appointed, and that gift will qualify for the federal gift tax marital deduction.
2 If Wife predeceases Husband, the assets over which she holds a general power of appointment will be included in her gross estate.
3) Any assets that pass from the revocable trust to Wife's Family Trust will not be considered a gift from the husband to the beneficiaries of the Family Trust.
4) Any assets that pass from the revocable trust to Wife's Family Trust will not be included in Husband's gross estate.

Favorable Ruling on Survivorship Life Insurance Trust

PLR 200404013

Facts: H is the grantor of an irrevocable life insurance trust (ILIT) that has purchased a survivorship life insurance policy on the lives of H and his wife, W. W and a corporate trustee are co-trustees of the ILIT and the beneficiaries of the trust are H and W's children and their descendants. The co-trustees have full discretion to distribute income and principal to the beneficiaries for the health, education, support or maintenance, as well as for purchase or improvement of a home, establishing a professional practice or acquiring an interest in a business.

H made a gift to the trust that was reported as a "split gift" with W and both H and W allocated GST exemption to the ILIT so that it would have an exclusion ratio of zero. All future premium payments will be funded by trust assets and neither A nor B will be making any additional contributions to the trust.

H may not be appointed a trustee of the trust nor may he remove or appoint a successor trustee. W has renounced any right to make contributions to the Trust and to appoint a successor trustee, and as trustee she has renounced her right to: 1) change the beneficiary of the policy; 2) revoke any change of beneficiary; 3) assign ownership of the policy; or 4) revoke any assignment of the policy.

The ILIT also has provisions for H's death (or earlier if the trust does not qualify as a grantor trust for income tax purposes) for S corporation stock owned by the trust to be held in a separate trust, one for each child or deceased child of H.

Ruling: The IRS ruled favorably on the following issues requested by the taxpayer:

1 The purchase by the Trust of the survivorship life insurance policy will not be treated as a gift by H or W.
2) W does not possess any "incidents of ownership" over the life insurance policy under IRC Section 2042 and the proceeds of the life insurance policy will not be included in H or W's taxable estate under Section 2042.
3) Since H and W split the gift to the trust, as long as the requirements for signifying consent under Section 2513(b) are met, the GST allocation will be treated as being made one-half by each of H and W. The purchase of the survivorship policy by the trust will not affect the transferors for GST purposes nor will it affect the inclusion ratio.

Discussion: This ruling clearly shows the benefit of having good counsel and careful drafting of a trust. It also shows that it is possible, with careful drafting, for one of the insureds to be a trustee of an ILIT that owns a survivorship policy. However, it would be necessary for anyone else to accomplish this to follow the same example, in terms of having the trustee spouse renounce certain powers.

IRS Issues Guidance on Early Distributions from Nonqualified Annuities

Notice 2004-15

The IRS has issued guidance on when distributions from nonqualified annuities before age 59 ½ will be treated as a "series of substantially equal periodic payments" (SOSEPPs) and exempt from the 10% penalty tax under IRC Section 72(q)(1). In this Notice, the IRS allows the same three methods for determining SOSEPPs as was allowed in Revenue Ruling 2002-62 for qualified plans and IRAs:

> 1) the required minimum distribution method; 2) the fixed amortization method; and 3) the annuitization method.

Notice 2004-15 indicated that Notice 89-25, as modified by Revenue Ruling 2002-62, will now apply for SOSEPPs from nonqualified annuities. The effective date of Revenue Ruling 2002-62 and now Notice 2004-15 is for any payments commencing on or after January 1, 2003. It appears that this Notice will have immediate effect for distributions from non-qualified annuities.

The release of Revenue Ruling 2002-62 marked several significant changes on how taxpayers under age 59½ can take a "series of substantially equal periodic payments" (SOSEPP) from their IRAs and qualified plans. Many taxpayers have used a fixed payment schedule to calculate this distribution amount. Because of the decline in market value from 2000-2002, many "fixed scheduled" taxpayers found themselves facing a total depletion of their IRA account balances using their current level of scheduled distributions.

Revenue Ruling 2002-62 replaced Notice 89-25 for distributions after 2002. The table below compares differences between the new and old "SOSEPP" distribution rules (republished from the November 2002 edition of *Central Intelligence)*.

Comparison of Notice 89-25, A-12, and Rev. Rul. 2002-62	**Notice 89-25 Rules**	**Revenue Ruling 2002-62**
What permissible methods are available to determine the amount of a SOSEPP?	Minimum distribution, amortization and annuity	Same: required minimum distribution (RMD), fixed amortization and fixed annuitization
What interest rate assumptions may be used for the amortization and annuity methods?	Any interest rate "that does not exceed a reasonable interest rate." No specific maximum but also no safe harbor. IRS had approved rates as high as 120% of the long-term AFR (see PLR 9747045).	Any interest rate that is not more than 120 percent of the federal mid-term rate "(determined in accordance with § 1274(d) for either of the two months immediately preceding the month the series of distributions begin)." The new specificity on rates provides both a safe harbor and fixed ceiling rate.
What life expectancy tables are available under the three methods?	For the RMD and amortization methods, the tables in the 1987 proposed minimum distribution regulations. For the annuity method, "a reasonable mortality table."	For all three methods, life expectancy must be determined using either the Single Life Table or Joint and Survivor Life Table from the final minimum distribution regulations, or the Uniform Lifetime Table contained in Revenue Ruling 2002-62 (a joint life table based on the ages of the participant and a hypothetical 10-years-younger beneficiary). A mortality table for determining factors under the annuitization method is also included in 2002-62.

If using the RMD method, is life expectancy determined using the fixed term method or redetermined annually?	Notice 89-25 did not address this question.	Life expectancy of the participant (and of his/her beneficiary, if using the Joint and Survivor Life Table) is redetermined annually.
If you use the RMD method based on a joint life expectancy of participant and beneficiary, what happens if the beneficiary changes during the no-modification period (say beneficiary dies or participant names a different beneficiary)?	Notice 89-25 did not address this subject. Changes to the beneficiary never matter under the amortization or annuity methods, because the payments, once determined in the first year, are a fixed amount. Similarly, beneficiary changes make no difference if participant uses the Single Life Table under the RMD method.	If using the Uniform Lifetime Table, it makes no difference who the actual beneficiary is at any point in time; participant must keep using the ULT. If using the Joint and Survivor Life Table, need to use the age of the designated beneficiary determined as of Jan. 1 of the distribution year, each year (or must use Single Life Table for that year if there is no designated beneficiary on Jan. 1).
What account balance do you use to determine the first payment in the SOSEPP?	Notice 89-25 did not discuss this subject.	"…account balance…must be determined in a reasonable manner." Revenue Ruling 2002-62 gives an example of a SOSEPP from "an IRA with daily valuations" that uses the RMD method and commences on July 15, 2003; "the value of the IRA from December 31, 2002 to July 14, 2003" would be ok. While this example remains somewhat unclear, it does not appear to change the rules or to be restrictive.
What account balance is used to determine subsequent payments under a SOSEPP if the RMD method is employed?	Notice 89-25 did not discuss this subject. Since payments are fixed under the annuity and amortization methods, there are no annual revaluations of the account.	Using the same example from above, "it would be reasonable to use the value either on December 31 of the prior year or on a date within a reasonable period of time before that year's distribution." In other words, the date does not have to be the same every year. Presumably, a participant could switch to a different valuation date to accommodate account value fluctuations.
What happens under the annuity or amortization method when the account runs out of money during the no-modification period?	Notice 89-25 did not discuss this subject.	Running out of money does not constitute a "modification" of the series. If participant does not relish that scenario, participant can switch to the RMD method. The RMD method requires an annual revaluation of the account.
Can the participant make any change in the design of a SOSEPP prior to expiration of the no-modification period?	No. However, the IRS did occasionally allow a taxpayer to make modifications on a case-by-case basis via private letter rulings, primarily to recognize a participant's loss of the account to an ex-spouse in a divorce.	If using the RMD method: No (except for the special relief for pre-2003 SOSEPPs; see below). If the participant begins using the amortization or annuity method, the participant may, after the first year, switch to the RMD method for such year and all subsequent years.

If the participant makes the permitted one-time switch from the annuity or amortization method to the RMD method, what life expectancy table do you use to determine subsequent distributions under the RMD method?	N/A	SOSEPPs commencing after 2002: The same life expectancy table used to calculate the initial payment under the annuity or amortization method before the switch must be used to determine payments under the RMD method after the switch. SOSEPPs commencing before 2003: Participant can choose any of three permitted life expectancy tables to compute payments under the RMD method after the switch. Regardless, if participant used single or joint life expectancies to compute payments under the initially adopted annuity or amortization method.
Are these three methods the exclusive means to determine the allowable SOSEPP distribution?	No. Notice 89-25 said the three methods "will be considered" acceptable, but did not limit the use of these three methods as the only acceptable methods. The IRS approved design variations in SOSEPPs, such as COLAs and annual revaluation in several PLRs.	Payments computed in accordance with the three methods "comply" with the Code. Remains unclear if the IRS intends to eliminate "private design" SOSEPPs.
What examples of forbidden modifications does the IRS provide guidance on with respect to SOSEPP distributions?	Notice 89-25 did not contain any examples of forbidden modifications.	An addition to the account (other than investment gains) will be viewed as a modification. A non-taxable transfer to another retirement plan will also be seen as a forbidden modification.
To what SOSEPPs does this guidance apply?	SOSEPP distributions commencing before 2002 or (optional) for 2002 series.	Revenue Ruling 2002-62 replaces Notice 89-25 for SOSEPPs distributions beginning after 2002. Revenue Ruling 2002-62 remains optional for SOSEPPs commencing in 2002.
What special relief does 2002-62 contain for pre-2003 SOSEPPs?	N/A	SOSEPP distributions that commence prior to 2003, regardless of the method used, may change "at any time to the [RMD] method."

Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance Issued

On February 11, 2004, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) jointly issued an advisory on the proper accounting treatment of deferred compensation agreements for key employees and bank-owned life insurance (BOLI). The agencies have determined that banking entities have not been accurately accounting for deferred compensation liabilities, particularly so-called revenue neutral plans or indexed retirement plans (collectively referred to in the advisory as IRPs). These plans tie benefits to the return on BOLI products that are purchased as the informal funding vehicle for the deferred compensation benefits. Basically, the advisory dictates that banking entities use generally accepted accounting principles (GAAP) for "booking" IRP deferred compensation liabilities and BOLI asset values. Essentially, this advisory brings accounting for deferred compensation arrangements in the banking industry in line with the proper accounting for deferred compensation in other sectors of the economy.

In addition to bringing accounting treatment in line with GAAP, banking entities are further required to determine whether any changes required by the advisory are "material". If material, the entity is required to report such changes as prior period adjustments. Non-material changes should be reported in current earnings.

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IRC Section 7520 Rate

April	2004	3.8%
March	2004	4.0%
February	2004	4.2%

The §7520 rate is used to value GRITs, QPRTs, CRATs, CLUTs, CLATs, private annuities, life interest, remainder and reversionary interests. To value a charitable gift for income, gift, or estate tax *charitable deduction* purposes, use either the rate for the month of the actual gift/transfer or the rate from either of the two previous months (use the highest of the three months for the largest charitable deduction).

Below-Market Rate Loans - AFR (April)

	Annual	S/A	Quarterly	Monthly
Short-term/AFRs loans (3 yrs or less)	1.47%	1.46%	1.46%	1.46%
Mid term AFR (more than 3 yrs up to and including 9 yrs.)	3.15%	3.13%	3.12%	3.11%
Long-term AFRs (more than 9 yrs)	4.66%	4.61%	4.58%	4.57%

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