

## **DOL Ruling on Life Insurance and Qualified Plans**

In Advisory Opinion 2002-12A, the U.S. Department of Labor ruled on the issue of transferring a term insurance policy or a whole life insurance policy in its first 3 years (neither of which has any cash surrender value) to a qualified profit-sharing plan account. A prior DOL ruling, PTE 92-5, allows qualified plan participants to transfer life insurance policies to individual accounts in a defined contribution plan as long as certain conditions are met. One of those conditions is that the plan may pay no more than the lesser of: 1) the cash surrender value or 2) the total value of the participant's account balance within the plan for the policy. Under the new Advisory Opinion, a qualified plan would not need to pay any consideration for term or new whole life policies if there is zero cash surrender value.

The Department of Labor did not address the tax consequences of transferring these policies. One possible implication is that the transfer of a policy with no cash surrender value to a qualified plan may be treated as an additional contribution to the account even if, according to this Opinion, the plan does not need to pay any consideration for a policy. Without additional guidance from the IRS it is difficult to determine the tax consequences of such a transfer based on this Advisory Opinion alone. To quote Stephan Leimberg, "One cannot necessarily conclude (based on this opinion) that the cash value of a policy is adequate valuation for income (gift, estate, and GST) tax purposes."

## **Estate Tax Repeal Legislation Introduced Again in Congress**

Several proposals to repeal the estate tax have been introduced in Congress. H.R. 57, introduced by Representative Jennifer Dunn (R-WA), would make the estate tax repeal permanent after 2010. Legislation similar to H.R. 57 passed the House last spring but was defeated in the Senate by 6 votes. In addition, Representative Christopher Cox (R-CA) introduced H.R. 51 which would immediately repeal the estate tax. In the Senate, Senator Blanche Lincoln (D-AK) sponsored S. 34, which would repeal the estate tax immediately only for family-owned businesses and farms.

It is anyone's guess as to how this legislation will fare in the 108th Congress – with a stagnating economy, impending war in Iraq, and the more pressing items in the President's stimulus proposal, even a Republican-majority Senate may not be able to secure passage of the estate tax repeal. However, the issue of estate tax repeal will certainly remain on the national agenda this year.

## **President Bush Presents His Administration's Economic Stimulus Proposal**

President Bush presented his Administration's economic stimulus proposal on January 7, 2003. Conservative estimates place the cost of this stimulus proposal at \$674 billion over the next ten years. The Administration plans to press hard to have President Bush's stimulus proposal passed by April 15. While estate tax repeal is not currently included in the President's current stimulus package, there may be attempts to add it to the package in the Senate Finance Committee or on the Senate floor. During a speech in Chicago on January 7, 2003, President Bush clearly expressed a commitment by his Administration to make the death tax repeal permanent.

## **Key components of President Bush's economic stimulus package include the following:**

- ◆ Elimination of income taxes on dividend income in 2003 -- \$364 billion.
- ◆ Acceleration of 2004 and 2006 income tax reductions from the 2001 tax cut in 2003 -- \$64 billion.
- ◆ Acceleration of Marriage Penalty Tax relief from the 2001 tax cut in 2003 -- \$58 billion.
- ◆ Increase in the Child Care Tax Credit from \$600 to \$1000 in 2003 -- \$91 billion.
- ◆ Accelerated Expansion of 10% tax bracket in 2003 (increased to \$7,000 per individual and \$14,000 per couple) -- \$48 billion.
- ◆ Increase in Small Business Section 179 Expense to \$75,000 in 2003 (indexed thereafter) -- \$16 billion.
- ◆ Individual AMT Relief through 2005 (increased by \$4,000 per individual and \$8,000 per couple) -- \$29 billion.
- ◆ State Aid (Reemployment Training and Homeland Security) -- \$3.6 billion.

The centerpiece of the Bush plan is the proposal to end personal income taxes on corporate dividends. During his Chicago speech, President Bush argued that such a change remains necessary to provide a major incentive to encourage investment by individuals and businesses. These investments in turn could potentially create new jobs and add \$20 billion to the economy in new investment activity.

Senate Democrats seem to generally be on board with the income tax rate reductions, marriage penalty tax relief, and raising the child care tax credit to \$1,000 per child in 2003 under the stimulus proposal. The Senate Democrats believe that these aspects of the proposal have more immediate stimulus effects than the elimination of the income tax on dividends.

Will the current stimulus proposal by the Bush Administration be pushed through Congress? Early indications are that the President's proposal may pass the House but will run into rougher times in the Senate. However, with the Republican control of the Senate anything is possible. We will keep you up to date on the future developments of President Bush's economic stimulus package.

## **Tax Court Grants Litigation Costs to Estate on Family Limited Partnership Case**

### **Estate of Dailey v Commissioner, T.C. Memo 2002-301**

In a decision that could signal an end to the IRS's attempts to disregard validly formed partnerships, the Tax Court awarded the Dailey estate \$42,700 of litigation costs against the government because the IRS's position to disregard the partnership was not "substantially justified." However, the Tax Court refused to grant or award litigation costs against the government for valuation issues. The Tax Court noted the inherent difficulties of valuation issues and that the government used an expert witness.

This Tax Court decision follows an original decision in this case (reported in the October 2001 edition of *Central Intelligence*). The Tax Court previously held that a 40% discount for lack of marketability and minority interest on gifts of limited partnership interests was appropriate (the partnership was funded with publicly traded stock). Following the decision of the original case, the estate moved for an award on costs and attorney fees against the government, on the grounds that the IRS was not substantially justified in its positions. The lack of substantial justification is the prerequisite standard for a party to prevail on an award on costs and attorney fees.

Here, the IRS conceded that it took a position "without substantial justification" as to whether or not the FLP involved a creation of a sham partnership. However, the IRS successfully contended that its position "was substantially justified" with respect to the valuation discounts taken on the gift and estate tax returns. The Tax Court agreed with the IRS on this point and allowed the taxpayer's estate to prevail only on an award of costs with respect to that portion (approximately 20%) of the estate litigation's costs expended on the validity issue of the partnership.

## Eleventh Circuit Follows Trend of Cases on Claims Against Estates

### Estate of O'Neal v. U.S., 258 F.3d 1265 (11th Cir. 2001)

The U.S. Court of Appeals for the Eleventh Circuit agreed with a recent trend of cases that the date of death value of a Section 2053(a)(3) deduction for claims against an estate should be determined without considering post-death events. On remand, the District Court harshly criticized the IRS for not presenting any expert testimony for the value of the claim at the date of the decedent's death.

**Facts.** The decedent had made lifetime gifts, and the IRS conducted a gift tax audit on the value of those gifts. After the statute of limitations had run against the donor for additional gift taxes, the IRS assessed additional gift taxes against the donees under a transferee liability. Litigation on the amount of these additional gift taxes was still taking place when the donor died.

The decedent's estate tax return claimed a debt for the full \$9.4 million of additional gift taxes asserted by the IRS, as "claims for reimbursement of transferee gift tax liability by the donees of 1987 gifts." Nine months after decedent's death, the Tax Court litigation was settled. The result was \$487,813 plus interest on the transferee gift tax liability.

The estate filed an amended estate tax return. The estate reduced its deduction for claims against the estate from \$9.4 million to \$563,314. However, the estate then filed a claim for refund, asserting that the estate should be able to claim a debt deduction for the full \$9.4 million claim that was asserted by the IRS at the date of death. The IRS maintained that the only deduction allowable was the actual amount of the settlement.

**Ruling.** The U.S. Court of Appeals for the Eleventh Circuit remanded the case to the district court for a determination on the date of death value of the claim, with clear instructions "neither to admit nor consider evidence of any post-death occurrences when determining the date of death value of a Section 2053(a)(3) deduction."

**Discussion.** The district court subsequently considered the issue of the valuation of the claim, without taking into consideration any post-death events. In its decision, the district court strongly criticized the IRS for not offering any expert testimony as to the valuation of the claim on the decedent's date of death. The court described in detail the types of expert testimony that would be helpful in valuing disputed claims, citing various cases. These include lawyers who settle or mediate those types of disputed claims, and a retired judge who practiced appellate law following retirement from the bench.

The district court concluded that the value of the restitution claim against the decedent-donor's estate was \$5,835,000. However, the court limited the amount of the deduction to the value of the estate assets subject to claims, \$5,307,744. The resulting 2053(a)(3) deduction eliminated the entire \$1,883,762 estate tax liability that had been paid by the estate.

## IRS Ignores Defined Value Formula for Gift Tax Purposes

### TAM 200247053

A trust made a small donation of limited partnership interests combined with a defined value formula sale of the trust's remaining limited partnership interests. The formula provision adjusted the amount of sold limited partnership interests downward, if the value of the limited partnership interest went up as a result of a gift tax audit. In this TAM, the IRS disregarded the formula adjustment clause.

**Facts.** Surviving parent, as trustee of a family trust ("family trust"), and her three children formed a limited partnership with cash, marketable securities and real estate. The family trust contributed 99.85% of the partnership property, and received a 0.85% general partnership interest, and a 99% limited partnership interest. Each child contributed cash in exchange for a 0.05% general partnership interest. On the same date, the parent established another trust for her descendants ("second trust"). The parent had a power of appointment over all of the income and principal of the family trust. The partnership agreement also specified that the fair market value of the 98.9% limited partnership interest shall be such value as finally determined for federal gift tax purposes based upon other transfers of limited partnership interests made by seller.

The sale was made for a promissory note and was secured by all of the second trust's interests in the partnership and the personal guarantees of the children. The parties later agreed to adjust the amount of limited partnership interest sold if there was an adjustment upon audit. The parent reported the transfer of the 0.1% limited partnership interest by the family

trust to the second trust as a gift on her federal gift tax return. She also disclosed the sale and purchase transaction between the trusts on her gift tax return, even though she represented that the sale was for fair market value.

**Ruling.** The IRS did not rule in favor of this arrangement. For starters, the IRS disregarded the formula adjustment clause. In doing so, the IRS stated that it “sees little or no difference between the effect of the adjustment clauses at issue in Ward and Revenue Ruling 86-41, and the adjustment provision in this case.” The IRS also saw little difference in effect between this case and the formula and the gift nullification provision described in Commissioner v. Procter. Finally, the IRS stated that the gift and sale were part of an “integrated transaction” that was not part of an arm’s length transaction because the parent was in fact dealing with herself.

The formula gift provisions in this case are subject to a bad fact pattern including: 1.) a partnership formation and an immediate gift/sale of almost all of the significant initial contributing partner’s interests; 2.) a gift of a “sliver” interest in what possibly was an attempt to trigger the running of the gift tax statute of limitation; 3) disclosure of a sale between trusts on an individual’s gift tax return; 4.) a sale controlled on both ends by the same person, and 5.) a valuation clause that was not adjustable if the value of the sold partnership interests was challenged only in an income tax setting.

Does this ruling mean that lifetime uses of valuation formula are not possible? Most commentators do not think so, even if some IRS personnel may believe that to be the case. The IRS should not have a problem with pure defined value gifts expressed as annual exclusions, unified credits, or GST tax exemptions, as valuation of subjectively valued assets presents significant difficulty. Also, the IRS should not have a problem with “old and cold” defined value gifts tied to annual exclusion, unified credit, or GST tax exemption amounts combined with sales of the remainder interest.

### **IRS Issues Section 645 Final Regulations to Combine Revocable Living Trusts with the Grantor’s Probate Estate for Income Tax Reporting Purposes**

Under the 1997 Taxpayer Relief Act and 1998 Internal Revenue Service Restructuring and Reform Act, Congress made it possible to combine most revocable living trusts with the grantor’s probate estate and to treat the trust and estate as a single tax entity for income tax purposes at the grantor’s death. The IRS recently released final regulations under Section 645 making this election. The Section 645 regulations became effective on December 24, 2002.

A qualified revocable trust (QRT) that can receive treatment as an estate or part of an estate under Section 645 must be a “defective” grantor trust under Section 676. The final regulations provide that if the trust can be revoked only with the approval of a non-adverse person, or with the consent of the grantor’s spouse, it still may qualify. The QRT definition does not include a revocable trust that during the grantor’s lifetime could be revoked only by the spouse acting alone, or by a non-adverse party acting alone. The definitions of non-adverse and adverse party are found in Sections 672(a) and 672(b).

An electing trust is one that makes a Section 645 election and will have this designation throughout the entire election period. The decedent will be the person designated as trust “owner” under Section 676. The decedent grantor’s probate estate will be designated as the “related” estate. The Section 645 election may be made even when a decedent’s estate does not have an executor. In such cases, the trustee of the QRT may make the election. If there is an executor, the election must be made by both the executor and trustee. A new election form (Form 8855) will be provided by the IRS entitled “Election to Treat a Qualified Revocable Trust as part of an Estate.” The new IRS form should be available 6 months after publication of the final regulations.

By signing the form, a trustee agrees to be bound by the election, and agrees to timely furnish all trust information to the executor of the related estate. There must be an agreement between the executor and the trustee to allocate the income tax burden of the combined entity. If there is no executor, the final regulations spell out a similar set of responsibilities for the trustee of the QRT. The election must be filed no later than the time prescribed for filing a form 1041 for the first taxable year of the combined entities, unless there is no executor. When there is no executor, the election must be filed on the date required for an electing trust under Section 6072. Each trustee and the executor are responsible for the timely payment of income tax due.

## **Lawsuits Against Insurance Carriers, Insurance Agents, Tax Plan Promoters, and Professional Advisors Are on the Rise**

There has been a recent surge of lawsuits against insurance carriers and agents, aggressive planning promoters, and professional advisors. The October 2002 Edition of *Central Intelligence* contained a summary of the Wal-Mart Stores, Inc. case that involved a lawsuit against two insurance carriers and charged the defendants in that case with negligence, misrepresentation, and breach of fiduciary duties related to the sale of COLI policies. In addition, the Wal-Mart Stores, Inc. suit charged the defendants with failing to disclose the full range and magnitude of tax-related and insurable interest risks associated with a COLI plan.

In another recent suit from New Jersey, the plaintiffs alleged misconduct of insurance agents during the solicitation process. The agents were trying to convince the plaintiffs to form a multi-employer welfare benefit plan. Attorneys for the insurance agents argued that ERISA preempted state law under the rationale that the lawsuit involved an employee welfare benefit plan subject to ERISA law. The defendant's attorneys made this argument because plaintiff avenues for redress face a much more limited set of remedies under ERISA than under state common law causes of action.

The New Jersey Court of Appeals held that the defendant insurance agents could be sued under state law for fraud, misrepresentation, and breach of fiduciary duty (Finderne Management Company v. Barrett, N.J. App., 2002). The New Jersey Court of Appeals rejected the defendant's arguments and held that the ERISA preemption of state law does not apply to circumstances where alleged misconduct occurs prior to the formation of a welfare benefit plan. Although the liability of the insurance agents in this case has not yet been determined, planners and agents should be aware that state law claims based on fraud and misrepresentations made during "pre-plan activity" or solicitation phases may not be subject to an ERISA exemption. Therefore, planners and insurance agents may be sued for making fraudulent claims or other material misrepresentations during business solicitations under state law.

In another case involving fraudulent tax promotions, a Chicago federal court enjoined Michael D. Richmond from selling fraudulent trust plans to help others evade income taxes. The Chicago federal court order also required him to post this barring mandate on his web site. The same court entered a similar order against Mr. Richmond's co-defendant, Rex E. Black. Mr. Black is currently in prison under a civil contempt charge for failing to comply with this court order.

These two very aggressive tax promoters and their organizations aided customers in federal tax law violations – through purported transfers of income and assets to bogus trusts. In addition, according to papers filed by government attorneys, Richmond and Black's "Liberty Institute" also trained over 2,500 people across the nation. These trainees took "certification" courses that resulted in a "Certified Estate Planner" designation. Upon "certification," Liberty agents then sold trust packages to customers for fees as high as \$3,750, plus additional annual charges for tax return preparation, "trustee services," and secretarial services.

In addition to barring the sale of these fraudulent trust plans and requiring the posting of the court order on their Internet websites, the court also made Richmond mail a copy of the injunction and government complaint to all his customers and all people who, since 1995, attended Liberty Institute courses, who had received titles such as "The Certified Estate Planner," "The Master Certified Estate Planner," "Charitable Planning Specialist," and "Elder Planning Specialist." The Chicago federal court also ordered Richmond to turn over his customer list to the Department of Justice and permanently banned him from federal income tax return preparations.

The injunction applied to Richmond personally as well as to affiliated organizations Richmond has used to promote the trust schemes -- The Liberty Network, Liberty Estate Planning, The Liberty Institute, Fiduciary Management Group, The National Council of Certified Estate Planners, Association for Certified Estate Planning Attorneys, and Eagle Publications Trust. Court papers showed that the National Association of Certified Estate Planners claims to have 730 Certified Estate Planners in 39 states. The IRS estimated the cost of Richmond and Black's activities to taxpayers at \$9 million per year.

In still another case in New York, several long time clients filed a major (\$40 million compensatory and \$1 billion in punitive damages) lawsuit against Ernst & Young, the law firms of Jenkens & Gilchrist, Sidley Austin Brown & Wood, and several of their partners for their roles in the promotion of a tax shelter scheme. This lawsuit charges the defendants with breach of fiduciary duty, fraud, negligence, breach of contract constituting professional malpractice, conspiracy to breach fiduciary duty, and tortious interference with contract. At this point, only the plaintiffs' side of the story is being told – the defendants have yet to respond.

According to the plaintiffs' brief, the case involves a proprietary tax shelter arrangement that required the signing of confidentiality agreements. Also, according to the plaintiffs' brief, the plaintiffs realized substantial capital gains of about \$70 million on transactions on which they fully expected to pay federal and state income taxes. The brief goes on to mention that without any prompting or requests from the plaintiffs, Ernst & Young used its prior knowledge of the clients finances and approached them with an "on-the-shelf" strategy to reduce or eliminate these taxes. The plaintiffs' brief further alleges that such professional advice proved "disastrous for them and despite paying millions of dollars to the defendants, the professional advice was erroneous and incompetent, and caused the plaintiffs to be subject to costly IRS audits, substantial tax liability including interest and penalties, and prevented the plaintiffs from availing themselves of other legitimate tax savings opportunities."

The plaintiffs' brief further alleges that the law firm of *Jenkins & Gilchrist* charged over \$2 million in fees in providing favorable opinion letters that the particular plan would not have to be registered as a tax shelter. Furthermore, the plaintiffs' brief goes on to mention that a second favorable opinion letter from *Sidley Austin Brown & Wood* stated the plan would not involve a tax sheltered investment that needed to be registered. This second opinion letter allegedly came at a cost of \$75,000. The plaintiffs' brief goes on to claim that the defendants knew or should have known from the outset this particular scheme would not survive an attack from the IRS or state tax authorities.

What can be learned from this last case (even though there has been no decision on the merits) and cases like *Wal-Mart Stores, Inc.* and *Finderne Management Company v. Barrett*? First, if it sounds too good to be true, it probably is too good to be true. Very aggressive tax planning techniques tend to have a way of turning out badly for everyone – planners, advisors, and clients alike. Second, there's a developing trend of new cases brought by plaintiffs because some particular planning advice or concept (tax, financial, or investment) does not turn out the way all parties hope – even if it involves advice clients want to hear so badly, they tend to suspend disbelief to accept. Third, planners and professional advisors need to constantly keep themselves informed as to the downsides, dangers, or doubts others have on the viability of a particular planning technique. New and aggressive tax promotion schemes are always lurking around the corner.

## **IRS Rules that Each IRA Beneficiary Can Use His or Her Life Expectancy on Separate Accounts from an Inherited IRA**

### **PLRs 200248030 and 200248031**

These two private letter rulings hold that each IRA beneficiary could use his or her life expectancy to determine the required minimum distributions on an inherited IRA. Each beneficiary created a separate account for his or her portion of the inherited IRA.

**Facts.** Taxpayer A died in 1999 after his required beginning date. Before Taxpayer A's required beginning date, A named Taxpayers B, C, and D (his children) as equal 1/3 beneficiaries of his IRA.

Following Taxpayer A's death, Taxpayers B and C arranged for their shares of the IRA to be separated from the account for Taxpayer D. Since the date of separation, the separate IRAs maintained for the benefit of Taxpayers B and C have their own gains, losses, contributions, and forfeitures (to the extent applicable) allocated without regard to the IRA(s) set up and maintained for the benefit of Taxpayer D (the oldest beneficiary).

The taxpayers sought a number of ruling requests. These two letter rulings involved the following requests:

1. Taxpayer A timely selected three individuals, Taxpayers B, C and D, as beneficiaries of his IRA.
2. Taxpayer C may be treated as a designated beneficiary for the portion of Taxpayer A's IRA maintained for the benefit of Taxpayer C. Similarly, Taxpayer B may be treated as a designated beneficiary for the portion of Taxpayer A's IRA that is maintained for the benefit of Taxpayer B.
3. For calendar years beginning in 2002, minimum required distributions from the IRAs set up in Taxpayer A's name for the benefit of Taxpayer B or C may be based on the Final 401(a)(9) Regulations and may be based on the Single Life Expectancy Table.

4. For calendar year 2002 and subsequent calendar years, the required minimum distribution(s) paid to Taxpayer C may be based on her remaining life expectancy of 34.0 years reduced by one for each calendar year after 2002. For calendar year 2002 and subsequent calendar years, the required minimum distribution(s) paid to Taxpayer B may be based on her remaining life expectancy of 38.7 years reduced by one for each calendar year after 2002.

**Rulings.** The IRS granted favorable ruling requests on all matters.

**Discussion.** The Final Regulations apply to determine the required minimum distributions for calendar years beginning on or after January 1, 2003. Furthermore, a taxpayer has an option of relying upon the Final Regulations for 2002 distributions. These two letter rulings were based on the Final Regulations.

Under the Final Regulations, separate accounts must be created no later than December 31st of the year following the year of the IRA owner's death. In these two letter rulings, taxpayers C and B did just that. Their separate accounts were created by the end of 2000, the year following the year of A's death. Because a designated beneficiary must be determined by September 30th of the year following the year of an IRA owner's death, prudence suggests separate accounts should be established no later than that date in order for each individual designated beneficiary to be considered the sole designated beneficiary of such account.

## **IRS Provides Filing Relief for Defined Benefit Plans**

### **Revenue Procedure 2003-10**

In Revenue Procedure 2003-10, the IRS postponed the time for amending defined benefit plans to comply with the 2002 minimum distribution regulations until the end of the EGTRRA remedial amendment period. The requirement to amend pre-approved defined benefit plans by December 31, 2003 remains postponed until further notice. In Notice 2003-2, the IRS also stated that it intends to issue transitional rules on the minimum distribution requirements for defined benefit plans and the use of annuity contracts.

This IRS action comes after hearings held on October 9, 2002 with respect to various aspects of the minimum required distribution regulations for defined benefit plans. Counsel for the AALU testified at the hearings on how the minimum required distribution regulations seem to prohibit distributions of variable annuities from those plans. Counsel for the AALU also testified that such a prohibition does not apply to distributions from defined contribution plans. It remains unclear if the IRS will modify the regulations as requested by the testimony from the AALU and others at the October hearings.

## **BECAUSE YOU ASKED**

### **Answers to Frequently Asked Questions of the Advanced Markets Team**

#### **Q. What About Revenue Ruling 2003-6 and the FLPSOP® Transaction?**

**A.** In the wake of Revenue Ruling 2003-6, The Advanced Markets Group has received several calls regarding the effect of Revenue Ruling 2003-6 on *FLPSOP*® transactions. We are happy to report that Revenue Ruling 2003-6 does not apply to *FLPSOP*® transactions. The *FLPSOP*® transaction is a conservative strategy that is designed for C corporations, not S corporations. Furthermore, the *FLPSOP*® transaction is designed for established, highly profitable companies who want to provide bona fide ESOP benefits for rank and file employees.

#### **Q. What Abusive Transactions Does the IRS Want to Stop in Revenue Ruling 2003-6?**

**A.** On December 17, 2002, the IRS released Revenue Ruling 2003-6. The Revenue Ruling is a very significant surgical strike by the IRS to protect legitimate ESOPs by putting a quick end to certain abusive ESOP structures in S corporations. The "S corporation ESOP Management Model" and several variations are the scam plans subject to Revenue Ruling 2003-6.

The ESOP community has opposed the proliferation of these scams and has worked closely with the IRS and Congress to put a stop to them. Congress addressed earlier abuses by adding Section 409(p) of the Internal Revenue Code as part of the 2001 Tax Act (EGTRRA). While Section 409(p) puts an end to some abusive structures, a technical loophole gave birth to the "S Corporation ESOP Management Model" concept.

## **Q. What Technical Loophole Does the “S Corporation ESOP Management Model” Concept and Similar ESOP Scams Attempt to Exploit?**

**A.** Section 409(p) uses disqualification provisions, income taxes, excise taxes, and penalties to deter abuses of S Corporation ESOPs. However, the “delayed effective date” of Section 409(p) provides a four-year window period for ESOP plans put in place on or before March 14, 2001. Several promoters set up hundreds of shell S corporations and ESOPs before March 14, 2001 and have been selling these shells to business owners for the purpose of availing themselves of the four-year window.

Revenue Ruling 2003-6 makes it clear that taxpayers who participate in such plans will NOT qualify for the four-year window and will NOT receive the promised tax benefits. Rather, small business owners may become subject to income tax and related penalties; the small business will be subject to a 50% non-deductible excise tax; and, because these scams have been deemed to be a “listed transaction” under the IRS’ corporate tax shelter rules, advisors who participate in these transactions will be subject to a 110% excise tax if they fail to comply with the onerous “listed transaction” rules.

## **Q. Will the IRS Attempt to Narrowly Close this Technical Loophole?**

**A.** Although the technical holding of Revenue Ruling 2003-6 is narrowly focused on the “delayed effective date” of the Section 409(p) provisions, the IRS has a much broader focus in mind. This Revenue Ruling makes it clear that the IRS will attack S corporation ESOPs that are designed to benefit owners and key employees at the expense of rank and file employees. The IRS has given notice that an S corporation ESOP must provide broad-based employee coverage and provide rank and file employees with more than “insubstantial benefits”. If the benefits being conveyed to rank and file employees are insubstantial compared to that of the original owner and key employees, the plan will be considered a sham. This result will create disastrous tax consequences for the owner of the corporation that sponsors the ESOP, the corporation itself, and advisors who participate in the transaction.

## **Q. Can You Describe in Greater Detail the Basic Form of the “S Corporation ESOP Management Model” Transaction?**

**A.** Again, the various forms of the “S Corporation ESOP Management Model” that have emerged over the last couple of years are scams designed to take advantage of a technical loophole found in the anti-abuse provisions under Section 409(p). While significant benefits (usually in the form of non-qualified deferred compensation) are provided to owners and key employees, rank and file employees receive benefits so insignificant as to be negligible. Such plans purport to be within the letter of the law but are not within its spirit. Let’s briefly consider how such a plan works.

An owner of a successful operating company sets up a thinly capitalized management company, and elects S corporation status for income tax purposes. The management company then creates an ESOP and the ESOP acquires all of the stock of the management company for a nominal price, say \$10,000. The operating company agrees to participate in the ESOP as an “additional adopting employer” and \$10,000 of stock is allocated among several hundred rank and file employees resulting in each employee receiving an ESOP benefit of less than \$100. The ESOP, a tax-exempt entity for federal income tax purposes, now wholly owns the management company. The owner and other key employees resign from the operating company and are employed by the management company. The management company then enters into a management contract with the operating company. The operating company agrees to pay the management company a “management fee” equal to the salary, benefits and non-qualified deferred compensation of the owner and other key people.

For the owner and key employees essentially nothing has changed, only the employer’s name on their W-2s. The management fee is deductible by the operating corporation. Here is the kicker - because the management fee includes the non-qualified deferred compensation element, the operating company gets to deduct CURRENTLY the cost of the non-qualified deferred compensation elections and the “S” corporation will then deduct the non-qualified benefit cost a second time when the non-qualified benefits are actually paid to key executives.

But what did the rank and file employees get out of this deal? They get to share in the equity value of the S corporation stock, which is negligible compared to the benefits being conveyed to key executives! Because the rank and file employees receive “insubstantial benefits”, Revenue Ruling 2003-6 says the ESOP is a sham. The tax benefits evaporate and a cloud of

penalties looms on the horizon. Worse yet, the IRS says that such plans are subject to the "listed transaction" rules. These rules also subject advisors who participate in such scams to an excise tax equal to 110% of the tax benefit received in the scam.

**Q. What Can You Do if You May Already Be Involved in One of These ESOP Scam Transactions?**

**A.** Unfortunately, you or your clients may already be a part of an abusive plan that Revenue Ruling 2003-6 seeks to stop. If you suspect that you or your clients are already part of such a scam, please call The Advanced Markets Group or contact your legal or tax advisors.

**Reminder: Electronic Distributions of Advanced Markets Materials are Available**

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**Stephan Leimberg to Speak About Charitable Planning on February 11, 2003**

Join Advanced Market's Randy Zipse on February 11, 2003 at 2PM ET when he hosts industry expert Stephan Leimberg in a discussion on charitable planning. Mr. Leimberg will talk about how to give a charitable presentation to clients as well as review popular charitable planning techniques. This call is scheduled to last one and one-half hours. For more information and to register please call (888) 266-7498, option 2 or visit [www.manulife.com/usinsurance](http://www.manulife.com/usinsurance).

**IRC Section 7520**

February, 2003	4.0%
January, 2003	4.2%
December, 2002	4.0%

The §7520 rate is used to value GRITs, GRATs, QPRTs, CRUTs, CRATs, CLUTs, CLATs, private annuities, life interest, remainder and reversionary interests. To value a charitable gift for income, gift, or estate tax *charitable deduction* purpose, 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 (February)**

	Annual	S/A	Quarterly	Monthly
Short-term/demand loans (3 yrs or less)	1.65%	1.64%	1.64%	1.63%
Mid-term loans (More than 3 yrs up to and including 9 yrs.)	3.27%	3.24%	3.23%	3.22%
Long-term loans (More than 9 yrs)	4.85%	4.79%	4.76%	4.74%

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