

Announcement 2005-80 Transaction-Specific Settlement Provisions

Given the scope of this initiative, the Service provides the following transaction-specific settlement provisions to assist taxpayers in making informed decisions in determining whether to resolve transactions under this initiative.

Rev. Rul. 2004-98 ("reimbursements" for a parking expenses previously paid by an employer or previously paid by an employee through a salary reduction), **and Rev. Rul. 2002-3 and Rev. Rul. 2002-80** ("reimbursements" of employees for salary reduction amounts previously excluded from gross income under § 106; "advance reimbursements" or "loans" without regard to whether an employee has incurred medical expenses).

Employees' wages for income and employment tax purposes include the following: purported reimbursements for health insurance premiums or parking expenses (previously paid by the employer or previously paid by an employee through salary reduction), advance reimbursements for medical expenses, purported loans for medical expenses, or administrative fees withheld pre-tax from wages in connection with any of these arrangements. All such purported reimbursements for health insurance premiums or parking expenses, advance reimbursements for medical expenses, purported loans for medical expenses and administrative fees withheld pre-tax from wages in connection with any of these arrangements are subject to Federal income tax withholding, FICA and FUTA taxes.

Rev. Rul. 2004-20, Situation 1 (pension plan fails to satisfy § 412(i) where amounts accumulated under life insurance contracts and annuities held by the plan exceed benefits payable under plan terms) and **Situation 2** (employer contributions to pension plan are not currently deductible when used to pay premiums on life insurance contracts that provide for death benefits in excess of the participant's death benefit under the terms of the plan), and **Rev. Rul. 2004-21** (pension plan fails to satisfy nondiscrimination requirements due to differences in the value of participants' rights to purchase life insurance contracts from the plan).

All deductions for open years for contributions to the plan will be disallowed. The plan must distribute the insurance contracts to plan participants and must be terminated. Any distributions must be included in participants' income at fair market value, with contracts valued at the sum of premiums paid. At the time of the distribution, the employer will be permitted to deduct the lesser of the amount of the contributions for which deductions were previously disallowed or the amount included in income by the participant upon the distribution of the contract. The distribution will be treated as a distribution from a nonqualified plan for purposes of §§ 72 and 402. Thus, for example, participants cannot roll over distributions to an eligible retirement plan (as defined in § 402(c)(8)(B)). An employer can resolve the transaction under this settlement initiative only if participants also enter into closing agreements reflecting these terms.

Notice 2004-8 (Abusive Roth IRA Transactions).

The transaction will be recharacterized as described in Notice 2004-8 and, thus, the individual taxpayer (Taxpayer) will be required to agree that the substance of the transaction is that the amount of value shifted (in the form of property transferred or payments made) from the pre-existing business controlled by the Taxpayer to the Roth IRA corporation is a payment to the Taxpayer, followed by a contribution by the Taxpayer to the Roth IRA, and then a contribution by the Roth IRA to the Roth IRA corporation. The excise tax under § 4973 will apply to the resulting excess contributions. Further, in appropriate circumstances, as described in Notice 2004-8, the Service may find that a prohibited transaction has occurred and, thus, the Roth IRA ceases to be an IRA and the entire value of the Roth IRA must be treated as a nonqualified distribution for that year, taxable to the individual and subject to the additional tax under § 72(t) unless an exception applies. Further, the Roth IRA will be required to disgorge amounts attributable to the transaction in a distribution that will be a nonqualified distribution to the extent not already so treated.

Rev. Rul. 2004-4 (transactions that involve segregating the business profits of an ESOP-owned S corporation in a qualified subchapter S subsidiary, so that rank-and-file employees do not benefit from participation in the ESOP).

For every year that is a nonallocation year and for which an individual with a right to acquire a qualified subchapter S subsidiary (Q Sub) of the S Corporation is a disqualified person, pursuant to Rev. Rul. 2004-4, the individual's interest in the Q Sub will be treated as synthetic equity during a nonallocation year and thus subject to the excise tax under § 4979A.

If any disqualified person is a participant in the ESOP and there are prohibited allocations to any disqualified person (within the meaning of § 409(p)) during any nonallocation years, the S corporation will be subject to the excise taxes imposed by § 4979A on prohibited allocations and the disqualified person will be subject to the deemed distribution rules of § 409(p)(2). Further, in such case, the plan will cease to be an ESOP, with the resulting tax consequences (such as the distributive share of income for S Corporation shares held by the ESOP being unrelated business taxable income to trust of the plan).

Further, in an appropriate case, the Service also may conclude that the plan never was, or has ceased to be, qualified under § 401(a), resulting in termination of the S Corporation election and other tax consequences. In appropriate cases, other tax benefits claimed by any taxpayer involved in the business structure may also have to be conceded. See Rev. Rul. 2004-4.

Any distributions from the ESOP that were made after the plan ceased to be qualified and that were rolled over to another retirement plan must be distributed from the other retirement plan as an amount not eligible for rollover. The individual may be subject to the excise tax under § 4973 for an excess contribution to an IRA.

In connection with this resolution, the S corporation may also be required to distribute the interests in the Q Subs. Finally, the S Corporation may be required to terminate the plan as a condition of resolving the transaction.

Notice 2003-24 (Tax Problems Raised by Certain Trust Arrangements Seeking to Qualify for Exception for Collectively Bargained Welfare Benefit Funds Under § 419A(f)(5)).

The plan must distribute all assets attributable to the employer's contributions. For plans that completed such distributions by December 31, 2004, all distributions are included in employees' income when received, except to the extent of amounts actually included in prior years. Life insurance contracts are valued at the sum of premiums paid. Employer contribution deductions are allowed when taken. For all other plans, the treatment is the same except that (1) for distributions made after 2004, the year of employees' inclusion is 2004 and life insurance contracts are valued at the sum of premiums paid by December 31, 2004, and (2) no employer contribution deductions are allowed after 2004.

Rev. Rul. 2003-6 (certain arrangements involving the transfer of ESOPs that hold stock in an S corporation for the purpose of claiming eligibility for the delayed effective date of § 409(p)).

Because the S Corporation ESOP was established after March 14, 2001, it will be subject to §409(p) effective for plan years ending after March 14, 2001. Thus, if a nonallocation year occurs for any plan year ending after March 14, 2001, the S corporation will be subject to the excise taxes imposed by § 4979A on prohibited allocations and synthetic equity and the disqualified person will be subject to the deemed distribution rules of § 409(p)(2). Further, the plan will be cease to be an ESOP. In an appropriate case, the Service also may conclude that the plan never was or has ceased to be qualified under § 401(a), resulting in termination of the S Corporation election and other tax consequences. Any distributions from the ESOP that were made after the plan ceased to be qualified and that were rolled over to another retirement plan must be distributed from the other retirement plan as an amount not eligible for rollover. The individual may be subject to the excise tax under § 4973 for an excess contribution to an IRA. Finally, the S Corporation may be required to terminate the plan as a condition of resolving the transaction.

Notice 95-34 (Tax Problems Raised by Certain Trust Arrangements Seeking to Qualify for 10 or More Employer Exception under § 419A(f)(6)).

The plan must distribute all assets attributable to the employer's contributions. For plans that completed such distributions by December 31, 2004, all distributions are included in employees' income when received, except to the extent of amounts actually included in prior years. Life insurance contracts are valued at the sum of premiums paid. Employer contribution deductions are allowed when taken. For all other plans, the treatment is the same except that (1) for distributions made after 2004, the year of

employees' inclusion is 2004 and life insurance contracts are valued at the sum of premiums paid by December 31, 2004, and (2) no employer contribution deductions are allowed after 2004.

Treas. Reg. § 1.643(a)-8 (Certain Distributions by Charitable Remainder Trusts).

Taxpayers must concede the recharacterization of an otherwise non-taxable distribution of trust corpus as a deemed sale of a pro rata portion of the trust assets followed by a distribution carrying out the capital gains realized in the deemed sale.

Management S Corporation ESOP Transactions (Transactions where the taxpayer has claimed that it is entitled to exclude income of an operating business by asserting, incorrectly, that the taxpayer had established, on or before March 14, 2001, an employee stock ownership plan entitled to an exemption from unrelated business income and an S corporation that is a management corporation, and whatever actions that were taken to attempt to establish an employee stock ownership plan and a management S corporation were taken on or before March 14, 2001.)

The Management S Corporation (hereinafter "MSC") must be dissolved and will be disregarded for federal income tax purposes. The taxpayer must agree that the ESOP, and any successor plan, was never a qualified plan under § 401(a), and the nonqualified trust must be terminated and its assets distributed to the ESOP participants if the trust has not already been terminated. The trust will be treated as terminated prior to January 1, 2005 for purposes of §§ 409(p) and 4979A. Assets from the nonqualified ESOP may not be rolled over to an eligible retirement plan (within the meaning of § 402(c)) or transferred to a qualified retirement plan.

If no cash or property payments were made to the MSC by the operating business: In the first taxable year for which the period of limitations under § 6501(a) has not expired (the first open year), the operating business will include in income the total amount of accrued payables to the MSC that were deducted in all prior years; in the first open year and all subsequent open years, the operating business will eliminate the current year deduction for management fees accrued to the MSC.

If some cash or property payments were made by the operating business to the MSC: To the extent payables were accrued by the operating business but were never paid to the MSC, the terms described in the preceding paragraph apply; and, if cash or property was paid by the operating business to the MSC in years prior to the first open year, the amount of all cash or property held by the MSC or ESOP, or rolled over from the ESOP to an IRA or other qualified plan during such years, is includible in the income of the participants in the ESOP in the first open year in proportion to their interests under the ESOP. For property, the amount includible is the tax adjusted basis as of the first day of such first open year in the hands of the MSC or ESOP. If cash or property was paid by the operating business to the MSC in an open year, the amount of cash or property (including earnings thereon) is includible in the income of the participants of the ESOP in proportion to their interest in the ESOP. In all open years, all losses or deductions of

the MSC or ESOP will be treated as incurred by the participants in proportion to their interest under the ESOP. As such, those expenses that are personal or non-business are not deductible and expenses attributable to amounts paid to or for the benefit of a particular participant shall not be deductible by the participant. For these purposes, any outstanding loans from either the MSC or the ESOP to the participants will also be includible as income to the participants in proportion to their interests under the ESOP. Loans made prior to the first open year are includable in the first open year. Any distributions from the ESOP that were rolled over to another retirement plan must be distributed from the other retirement plan as an amount not eligible for rollover. The individual may be subject to the excise tax under § 4973 for an excess contribution to an IRA.