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Small Business Job and Credit Act of 2010 Greatly Reduces Tax Penalties Against 412(i) Plan Participants

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Insurance companies, marketing representatives, registered representatives, insurance agents and tax preparers have been ensnared in litigation involving the recommendation, proposal, implementation and tax consequences associated with 412(i) defined benefit pension plans ("412(i) plans"). In response, Congress has passed legislation to address some of the perceived inequities of tax penalties associated with these plans.

In the typical scenario, a taxpayer decided to establish and implement a 412(i) plan which was fully funded by the purchase of life insurance policies. Since the 412(i) plan was qualified, it permitted the employer to take a deduction to the extent of its contributions to the 412(i) plan. The contributions to the 412(i) plan made on behalf of the employee were not includable in the employee's income in the taxable year of the contribution.

In many circumstances, the insurance policy purchased to fund the 412(i) plan was a whole life insurance policy subject to surrender charges. The surrender charges were substantial and significantly declined after the employee's interest in the plan vested or he/she reached retirement age. The significant surrender charges suppressed the insurance policy's cash value and the policy's death benefit under the contract would exceed the participant's death benefit under the plan. However, the cash value would "spring" after the employee's interest vested as a result of the declining surrender charges.

On February 13, 2004, the IRS issued Revenue Ruling 2004-20 providing examples of what the IRS believed would constitute a listed transaction which would be a reportable transaction requiring the filing of a Form 8886 Reportable Transaction Disclosure Statement under which listed transactions are disclosed to the IRS. Revenue Ruling 2004-20 explained that a transaction similar to a transaction where an employer deducted amounts used to pay premiums on life insurance contracts for a participant with a death benefit under the contract that exceeded the participant's death benefit under the plan by more than $100,000 would be considered a reportable transaction and, therefore, a listed transaction.

If a transaction was deemed to be a listed transaction but not reported then Section 6707A of the Internal Revenue Code required that a $200,000 fine for a corporation and a $100,000 for an individual taxpayer be assessed against such non-reporting corporation or individual. These penalties were assessed for each tax year in which the taxpayer failed to disclose the listed/reportable transaction.

After the release of this Revenue Ruling in 2004, the IRS assessed penalties under 6707A often times in the amount of $200,000 per year for a small corporation and $100,000 per year for the sole shareholder of this small corporation. Additionally, the IRS assessed penalties under 6707A for not only one year but often times for multiple years. The IRS assessment for such penalties over multiple years resulted in very large penalties for small corporations with only a single shareholder. The result of these large penalties being assessed had the effect of driving small corporations into bankruptcy since they were unable to pay such large penalties. In addition, the penalty did not relate to the amount of the tax avoidance resulting from the corporation's actual pension deduction in the amount of the contribution to the defined benefit plan.

If, for example, a corporation was in the 35% tax bracket, it contributed $100,000 to the defined benefit plan and took a $100,000 deduction in the tax year for which the IRS issued an assessment,

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then the tax avoidance is a percentage of the $100,000 deduction. However, the penalty under 6707A against the corporation and the individual sole shareholder could have been as high as $300,000 for one tax year. As a result of this large inequity between the penalties and the actual tax avoided the IRS placed a moratorium upon the collection of such penalties. However, the moratorium expired in June of 2010. In order to address this inequity, the President signed into law the Small Business Jobs and Credit Act on September 27, 2010. The Small Business Jobs and Credit Act reduced and limited the penalties for failure to disclose reportable transactions based on resulting tax benefits. The Act amended 6707A of the Internal Revenue Code and under the new amended 6707A, the amount of the penalty with respect to any reportable transaction shall be 75% of the decrease in tax shown on the return as the result of such transaction. Furthermore, the Act set forth the maximum penalty under 6707A in the case of a listed transaction as $200,000 ($100,000 in the case of a natural person), or in the case of any other reportable transaction, $50,000 ($10,000 in the case of a natural person). The minimum penalty under Section A with respect to any such transaction should not be less than $10,000 ($5,000 in the case of a natural person). The maximum and minimum penalties are a cap and floor to the potential penalties that may be assessed under 6707A. The amendment was applied retroactively to penalties assessed after December 31, 2006.

Therefore, the penalties have been significantly reduced and relate specifically to the amount of tax avoided through a deduction for contributions to 412(i) plans which the IRS believes are reportable transactions based on the type of insurance policy purchased to fund the 412(i) plan. Under the 6707A Amendment, if a taxpayer is in a 35% tax bracket and took a $100,000 pension deduction, which the IRS later decided was an unreported listed transaction, the new penalty under 6707A would only be 75% of the tax avoided by way of the deduction.

The Act addresses the prior inequity with respect to the amount of penalties being assessed and also makes the penalties relate to the actual reduction in taxes shown as a result of the disputed transaction.

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