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Subject: **Court Rules That Statements Made Prior to 2004 Regarding Revenue Code Section 412(i) Plan Do Not Constitute Fraud**

Major References: [*Patel, et al. v. Pacific Life Insurance Co., et al., Civ. Action No. 3:08-CV-248-B-BD, consolidated with Civ. Action No. 3:08-CV-249-B-BD \(N.D. Texas, August 27, 2010\)*](#)

Prior AALU Washington Reports: 09-95; 09-69,06-42; 06-38; 04-29, 04-28, 04-27 and 89-30

MDRT Information Retrieval Index Nos.: 5400, 6510, 7400

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The Federal Court in the Northern District of Texas has ruled that guidance issued in 2004 and 2005 relating to specially-designed insurance contracts used to fund 412(i) plans cannot be used to prove fraud for statements and representations made by sellers and promoters of such plans prior to the issuance of the 2004 guidance.

In *Patel v. Pacific Life Insurance Co.*, Pratul M. Patel, M.D., P.A. (Dr. Patel's professional corporation) established a 412(i) plan based upon information and recommendations made by, among others, an agent of defendant Pacific Life Insurance Co. ("Pacific Life"). The plan created was a defined benefit plan funded with specially-designed Pacific Life insurance contracts intended to satisfy the requirements of Code section 412(i). By satisfying that provision, the plan would be excepted from the normal funding rules for defined benefit plans. In 2005, two years following the plan's establishment, the plan was under audit by the IRS.

In the complaint, plaintiffs, Pratul M. Patel and Pratul M. Patel, M.D., P.A., have alleged that, unbeknownst to them, the plan as designed was in actuality an illegitimate tax shelter because it was funded by a specially-designed insurance policy with high premiums, a low cash surrender value, and a

death benefit at least \$100,000 in excess of the plan's death benefit. According to the complaint, the defendant knew or should have known that the plan would have been scrutinized by the IRS and deemed abusive and illegal. The plaintiffs have further alleged that defendant, focused on the fees, failed to disclose the risks associated with the plan. In a decision on May 22, 2009, the Court granted the defendant's motion to dismiss because, among other things, the claims of negligent representation and fraud failed to contain information regarding (1) when the alleged representations were made; (2) where the alleged representations were made; (3) why the alleged representations were false or misleading when made; and (4) what facts Pacific Life failed to disclose and why those omitted facts make the affirmative representations misleading. The Court, however, gave the plaintiffs the opportunity to fix the complaint against Pacific Life to include the information required for claims of negligent representation and fraud. For more information on the Court's initial decision, see our Bulletin No. 09-69.

The plaintiffs filed an amended complaint against Pacific Life a little over a month following the Court's decision. In the amended complaint the plaintiffs alleged that statements made in 2003 regarding the legality of the plan were false, given the guidance issued by the IRS prior to 2001 regarding the valuation of insurance contracts distributed from qualified plans, specifically citing Announcement 88-51 and Notice 89-25. The complaint further alleges that later guidance issued, particularly Revenue Procedure 2004-16 and T.D. 9223 (70 Fed. Reg. 50,967), did not represent a change in the law. For more information regarding this later guidance, see our Bulletins Nos. 04-27, 04-28 and 04-29.

In the second *Patel* decision, the Court ruled that the amended complaint failed to plead successfully negligent representations and fraud because it did not explain why the alleged representations were false when made in 2003. In Announcement 88-51, the IRS stated that it was studying the impact of insurance contracts with low cash surrender values within the context of nondiscrimination rules, distribution rules and annual limitations applicable to qualified plans. The IRS noted that in certain situations a valuation method other than a contract's cash surrender value should be used to determine taxation under section 72. Notice 89-25 provides that the cash surrender value of an insurance contract distributed from a qualified plan should not be used to determine includibility in income if the total policy reserves represent a much more accurate approximation of the fair market value of the policy than does the policy's stated cash surrender value. For more information regarding Notice 89-25, see our Bulletin No. 89-30. The Court determined that neither of these pieces of guidance was definitive about the legality of funding 412(i) plans with specially-designed insurance policies. Consequently, Announcement 88-51 and Notice 89-25 could not be used to prove that the statements made by the defendant's agent were false when made in 2004.

The Court acknowledged that guidance issued subsequent to the plan's establishment did call into question the viability of the plan. The Court specifically cites, among others, Revenue Ruling 2004-20, which clarifies the deductibility of plan contributions to 412(i) plans funded by life insurance policies with death benefits in excess of the participant's death benefit under the plan's terms and provides that such plans are subject to the reporting requirements for "listed transactions" if the employer has deducted contributions used to pay premiums on policies where the death benefit exceeds plan's death benefit by more than \$100,000. For more information regarding Revenue Ruling 2004-20, see our Bulletins 04-27, 04-28 and 04-29. The Court concluded however that, as a matter of law, regulations and rulings issued in 2004 and 2005 cannot be used to show that statements made in 2003 were then false.

The second decision in *Patel* is relevant because it provides that guidance issued by the IRS in 2004 and 2005 regarding the legality of certain types of 412(i) plans cannot be used to prove fraud relating to statements and representations regarding such plans prior to the release of the guidance. Although this concept was addressed in the earlier decision in *Patel*, it was not the basis for the Court's dismissal. Now, with the second *Patel* decision, Court makes clear that no legal basis exists for alleging fraud for pre-2004 statements regarding the legality and viability of certain 412(i) plans.

We note that there are a number of cases pending that are based, in whole or in part, on claims against insurers and their agents and/or advisors for the sale and promotion of section 412(i) Plans. In certain of these cases, the courts have granted motions to dismiss against some of the plaintiffs in part because the plans were promoted and sold prior to the issuance of the 2004 rulings and subsequent guidance. Compare *Berry v. Indianapolis Life Insurance Company*, discussed in our Bulletin No. 09-95 and *Kennard v. Indianapolis Life Insurance Company*, in which the court, on similar alleged facts, refused to grant dismissal. (See our Bulletins Nos. 06-38 and 06-42.)

Any AALU member who wishes to obtain a copy of the second decision in *Patel, et al. v. Pacific Life Insurance Company, et al.* (August 27, 2010) may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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