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TAX ISSUES SUMMARY

May 28, 2004

HIGHLIGHTS:

FSC/ETI Repeal and Bills to Jumpstart Our Economy

The Senate, on May 11th, agreed to replace the FSC Repeal and Extraterritorial Income Exclusion Act (“ETI Act”) with tax breaks for corporations and U.S. manufacturers by approving the Jumpstart Our Business Strength Act (“JOBS Act”) (S. 1637), by a 92-5 vote. The bill contains several provisions that will affect the insurance industry. See Legislation.

I.R.C. § 223 — Ruling Issued on Eligibility to Make Contributions to HSAs

In Rev. Rul. 2004-45, 2004-22 I.R.B. ____, the IRS determined that individuals are not eligible to make contributions to health savings accounts (“HSAs”) in situations where reimbursements made by health flexible spending arrangements (“health FSAs”) and health reimbursement arrangements (“HRAs”) are not limited to permitted exceptions. Through the use of five examples, the IRS demonstrated that when a health FSA and/or an HRA pays or reimburses expenses not limited to exceptions for permitted insurance, or permitted coverage or preventive care, the individual is not eligible to make contributions to an HSA. See Policyholder Issues.

LEGISLATION

1. FSC/ETI Repeal and Bills to Jumpstart Our Economy

After months of debate, the Senate passed the Jumpstart Our Business Strength Act (“JOBS Act”) (S. 1637) on May 11th with a 92-5 vote. The JOBS Act would repeal the ETI Act and replace it with tax breaks for corporations and U.S. manufacturers. The bill would also extend tax provisions due to

expire this summer, provide \$18 billion in energy tax breaks, and offer several other targeted tax provisions. Provisions included in the bill that specifically will affect the insurance industry are:

- Expansion of the de minimis rule under subpart F;
- Amendment of I.R.C. § 845(a) to clarify that adjustments between related parties can be made as to income amounts, as well as allocation of income and deduction, and character;
- Repeal of reduction of deductions for mutual life insurance (I.R.C. § 809); and
- Suspension of policyholders surplus account provisions under I.R.C. § 815.

The bill also has provisions designed to hamper abusive corporate inversions and tax shelter transactions such as the codification of the economic substance doctrine, stricter disclosure requirements, and a crack down of sale-in, lease-out (“SILO”) transactions.

The House is expected to consider some version of The American Jobs Creation Act of 2003 (H.R. 2896), which was approved by the House Ways and Means Committee last October but has yet to reach the House floor. The House bill would include some broad international tax reforms, providing relief for U.S. multinationals and providing less relief for domestic U.S. manufacturers than in the Senate bill. The House bill is expected to cost revenue, while the Senate bill is basically revenue-neutral. Currently, the House Ways & Means Committee is expected to re-markup the House bill and, hopefully, to take the bill to the House floor in the early part of the summer. When a conference and final action will occur might depend on whether the impact of the WTO imposed tariffs on U.S. goods really begin to hurt.

2. House Passes Four “Message” Bills

A series of four Republican-backed bills has been passed by the House to provide extensions for four popular but expiring tax cuts enacted under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Pub. L. No. 108-27). H.R. 4181, passed on April 28th, provides for relief from the marriage penalty. H.R. 4227, passed on May 5th, provides a one-year extension of additional alternative minimum tax relief, adjusted for inflation, for individual taxpayers. H.R. 4275, passed on May 13th, expands the 10% income bracket. Finally, H.R. 4359, passed on May 20th, provides for a permanent \$1,000 child credit. The passage of the bills has sparked partisan debate, with the Democrats criticizing them as being merely “reelection bills,” showing a lack of fiscal responsibility. Although the subjects of the four tax bills are generally popular on the Senate as well as the House side, the Senate is likely to require revenue offsets if and when the extender provisions are taken up.

3. Senate Committee Reports on NESTEG Legislation

On May 14th, the Senate Finance Committee released its report on the National Employee Savings and Trust Equity Guarantee (“NESTEG”) Act. The original bill, considered late last year, was reconsidered again in February due to heated debate over an amendment including corporate-owned life

insurance (“COLI”) provisions. The markup that was approved by the Committee in February includes pension provisions on participant protections and executive and deferred compensation restrictions, as well as pension funding reforms and portability improvement proposals. The markup also includes more moderate provisions on the tax requirements for and use of COLI contracts.

POLICYHOLDER ISSUES

1. I.R.C. §§ 61 and 817(h) — Earnings on Life Insurer’s Separate Accounts Not Includable as Income for Contract Holders

In PLR 200420017 (Feb. 2, 2004), the IRS determined that owners of variable annuity and life insurance contracts that meet the I.R.C. § 817(h) diversification requirements do not have to include earnings as income when the assets underlying the contracts are allocated to a general account fixed investment option as well as a life insurance company’s variable investment separate accounts, and new variable investment options are added. In the ruling, a stock life insurance company offered deferred and variable annuity contracts that permitted the owner to allocate premiums between fixed and variable investment options. Premiums allocated to the fixed investments were allocated to the general account of the insurance company and premiums allocated to the variable investments were held in a separate account. The insurance company intends to offer variable life insurance contracts with investment options the same as those currently available to annuitants. In addition, investment portfolios will be established under the new contracts, with each of the portfolios being treated as a new sub-account of the insurer’s existing separate accounts, and considered a regulated investment company (“RIC”) under I.R.C. § 851. The contract owners will be able to allocate premium and transfer dollars among the portfolios. Each portfolio will represent a different investment strategy and selection of the portfolio assets (which may be RIC shares available to investors other than through the purchase of a variable contract) will be determined by an investment manager.

In determining whether, for federal tax purposes, the life insurance company would be treated as the owner of the assets in the new sub-accounts, the IRS examined whether the contract owners possessed sufficient incidents of ownership over the assets. Considering all relevant facts, the IRS concluded that the contract owners lacked both direct and indirect control over the investments underlying their contracts and could not be considered the owners of the sub-account assets. Consequently, the IRS ruled the life insurance company would be treated as the owner of the assets in the sub-accounts and, if the life insurance and annuity contracts continue to satisfy the diversification requirements of I.R.C. § 817(h), the contract owners would not have to include earnings on separate account assets as income.

2. I.R.C. § 223 — Ruling Issued on Eligibility to Make Contributions to HSAs

In Rev. Rul. 2004-45, 2004-22 I.R.B. ____, the IRS determined that individuals are not eligible to make contributions to health savings accounts (“HSAs”) in situations where reimbursements made by health flexible spending arrangements (“health FSAs”) and health reimbursement arrangements

("HRAs") are not limited to permitted exceptions. The ruling examines whether contributions may be made to HSAs in five scenarios in which an individual has coverage under a high deductible health plan ("HDHP") with 80/20 coinsurance above the deductible, as well as a health FSA and/or an HRA. The IRS analyzed the Code provisions and legislative history regarding contributions to HSAs (I.R.C. § 223) and the benefits of health FSAs (I.R.C. § 125), as well as the IRS' tax treatment of HRAs (Notice 2002-45, 2002-2 C.B. 93). When a health FSA and/or an HRA pays or reimburses expenses not limited to exceptions for permitted insurance, or permitted coverage or preventive care, the individual is not eligible to make contributions to an HSA. Thus the IRS concluded that when an individual is covered by a health FSA and/or an HRA, such that all I.R.C. § 213(d) medical expenses not covered by the HDHP are paid or reimbursed, that individual is not eligible to make HSA contributions.

COMPANY ISSUES

1. I.R.C. § 265 — Guidance Issued on Consolidated Groups' Interest Deductions for Exempt Investments

In Rev. Rul. 2004-47, 2004-21 I.R.B. 941, the IRS issued guidance explaining the disallowance of interest deductions in relation to whether the funds are traceable to borrowings used to purchase or carry tax-exempt obligations. The ruling considers several factual situations in which a member of an affiliated group borrows money from a nonmember party, then transfers the money to another member of the group that is a dealer in tax-exempt obligations. The ruling holds generally that an allocable portion of interest expenses of a member of an affiliated group should be disallowed under I.R.C. § 265(a)(2) where that member makes contributions of the borrowed funds to another member that is a dealer in tax-exempt obligations. Using the allocation formula of Rev. Proc. 72-18, 1972-1 C.B. 740, this disallowance applies whether or not the contributions to the dealer are traceable to the dealer's purchase or carry of tax-exempts. However, the ruling clarifies that there should be no interest disallowance under I.R.C. § 265 if there is no linkage between the borrowed funds and contributions to the affiliated dealer in tax-exempts.

The IRS also released proposed regulations (REG-128590-03, 2004-21 I.R.B. 952) on this issue. Under the regulations, a member of a consolidated group cannot exclude from interest income attributable to intercompany indebtedness when the interest deduction is disallowed to another member of the group because of I.R.C. § 265. Comments have also been solicited on whether regulations should be proposed regarding how I.R.C. § 265 should be applied in the context of multiparty financing arrangements and transactions involving related parties, pass-throughs and other intermediaries. Comments are requested to be submitted by August 5, 2004.

2. I.R.C. §§ 368 and 833 — Corporation Must Compute Deduction Including Adjusted Surplus of All Merged BCBS Companies

TAM 200418009 (Jan. 20, 2004) concludes that a corporation resulting from the merger of two Blue Cross/Blue Shield ("BCBS") companies must include the adjusted surplus of each company in the

calculation when computing its I.R.C. § 833 deduction. In the facts of the ruling, two companies, both of which were parents of consolidated groups that claimed the special deduction allowed to BCBS companies under I.R.C. § 833(a)(2), merged in a tax-free reorganization under I.R.C. § 368(a)(1)(A). As a result of the transaction, both companies were terminated under state law. One consolidated group filed a final consolidated return for the short year, while the second consolidated group filed a consolidated return with the new emerged corporation as its parent company. In an amended return, the new group calculated its I.R.C. § 833 deduction taking into account only the second company's adjusted surplus. After reviewing the Code and legislative history, the IRS concludes that, under I.R.C. § 833(c), the new corporation qualifies for treatment as a BCBS organization. As an amalgamation of its parts, the new corporation must compute its adjusted surplus by combining the adjusted surplus for both companies as of the first day of its first taxable year.

3. I.R.C. § 806 — Stock Life Insurance Company Allowed to Gross Up Interest Deductions from Acquisition Indebtedness

TAM 200420002 (Jan. 6, 2004) concludes that, under the Huddleston amendment, a stock life insurance company is entitled to grossed up interest deductions with respect to the investment partnership of a company with which it merged. In 1984, section 217(k) of the Deficit Reduction Act (Pub. L. No. 98-369) lowered the effective tax rate on income from insurance business for all life insurance companies. Under an amendment to the act, proposed by Senator Huddleston ("the Huddleston amendment"), certain life insurance companies were permitted to exclude the interest deductions related to the acquisition of the stock of another corporation by means of a partnership using debt financing, in effect grossing up the insurance company's related interest deduction such that interest payments continued to provide a tax benefit at the effective tax rate of the prior law. In 1986, this provision was amended, allowing qualifying life insurers to gross up all items of income, gain, loss or deduction attributable to the ownership of stock related to the acquisition by 125% in computing taxable income.

In the facts of the TAM, Company A and its two life insurance subsidiaries created an investment partnership, which used a purchase money debenture due in 2006 to finance the acquisition of a life insurance subsidiary. Company A's investment partnership qualified for the exclusion under the Huddleston amendment. Company A was subsequently acquired by the foreign parent of a stock life company in exchange for stock of the parent company. The life insurance operations of Company A were transferred to a holding company and were merged into the parent's stock life company. Because the merger resulted in a disproportionate asset acquisition for the five-year affiliation requirement of I.R.C. § 1504(c)(2), the stock life company ceased to be an eligible member of the life-nonlife group and was required to file separate returns. In computing its taxable income, the stock life company grossed up interest expenses related to Company A's investment partnership under the Huddleston amendment. The TAM concluded that the stock life company should be eligible to claim the benefit of a grossed up interest deduction under I.R.C. § 806(a). Despite the fact that the Huddleston amendment was designed to apply narrowly, the acquisition and merger of Company A should not result in the termination of the benefits under the Huddleston amendment while the acquisition indebtedness remained outstanding. The IRS also found that the transaction was not a sham even though the parties were related, stating that tax rules

implicitly recognize that valid indebtedness may exist between related parties. The stock life company therefore should be allowed to gross up the interest deductions related to Company A's investment partnership.

4. Schedule M-3 to be Finalized

The IRS announced that the new Schedule M-3, Net Income (Loss) Reconciliation for Corporation With Total Assets of \$10 Million or More, will be finalized by June 30th. While Sarbanes-Oxley compliance works to create transparency for financial accounting purposes, the implementation of this schedule is one of the steps being taken by the IRS to increase transparency on corporate returns. The new form will require taxpayers to separately state and disclose differences between income and loss for tax purposes and the amounts reported for financial reporting purposes. In response to comments it received, the IRS also stated that it is considering pushing back the date for determining whether a corporation has more than \$10 million in assets in relation to its filing deadline.

The property and casualty insurance industry has raised questions about whether filing Schedule M-3 makes any sense for insurance companies given the heavy reliance of the tax code on annual statement accounting (while the Schedule M-3 differences key off of GAAP calculations) and the nature of insurance recordkeeping. Word on the street is that certain property/casualty companies have received word from Treasury indicating possible exemption from the Schedule M-3 requirements if the return filed for the company is a Form 1120-PC. The exemption presumably would not apply if the property/casualty company is a member of a consolidated group for which the ultimate parent is not a property/casualty company.

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