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TAX ISSUES SUMMARY

June 30, 2004

HIGHLIGHTS:

FSC/ETI Repeal Bills to Jumpstart Our Economy — Going Nowhere Fast

Both the House and Senate began their July 4th recesses without moving forward on outstanding tax bills. Despite the fact that the House passed H.R. 4520, the American Jobs Creation Act of 2004, repealing the export tax subsidy known as FSC-ETI, and the Senate already had passed its version of the ETI repeal in the Jumpstart Our Business Strength Act (“JOBS Act”) in May, the Senate failed to take the necessary actions before its recess to move the bills to a conference. Now, the conference is not expected until mid-summer, with nothing final expected until the fall. See Legislation.

I.R.C. § 864 — Proposed Regulations Issued on Stock Held by Foreign Insurers

The IRS issued REG-117307-04, a proposed regulation that provides that the exception to the asset-use test for stock shall not apply for purposes of determining whether the income, gain, or loss from portfolio stock held by foreign insurance companies constitutes effectively connected income. See Company Issues.

LEGISLATION

1. FSC/ETI Repeal Bills to Jumpstart Our Economy — Going Nowhere Fast

Both the House and Senate began their July 4th recesses without moving forward on outstanding tax bills. On June 17th, the House passed H.R. 4520, the American Jobs Creation Act of 2004, by a vote of 251-178, repealing the export tax subsidy known as FSC-ETI, ostensibly to end the retaliatory sanctions being imposed by the European Community on American products. The bill also would reduce the top corporate tax rate from 35% to 32% for United States manufacturing and small corporations and provide some simplification for international tax law. Like its Senate counterpart, the House bill’s provisions are

said to be aimed at creating American jobs by reducing taxes, ending sanctions and encouraging business investments to generate American job growth. Despite the fact that the Senate passed its version of the ETI repeal in the Jumpstart Our Business Strength Act (“JOBS Act”) (S. 1637) on May 11th with a 92-5 vote, the Senate failed to take the necessary actions before its recess to move the bills to a conference. Now, the conference is not expected until mid-summer, with nothing final expected until the fall.

Despite pessimism for any expedited treatment, there are provisions included in the bills of which the insurance industry should be aware. Both bills include provisions to expand the de minimis rule under subpart F, as well as to amend 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. Also, both bills have provisions designed to hamper abusive corporate inversions and tax shelter transactions such as stricter disclosure requirements and a crack-down of sale-in, lease-out (“SILO”) transactions. In addition, the Senate bill has provisions that would repeal I.R.C. § 809 for 2004, suspend policyholders surplus account provisions under I.R.C. § 815, and modify further the exemption from tax for small property and casualty insurance companies under I.R.C. § 501(c)(15). The modification states that a property and casualty insurance company is eligible to be exempt from federal income tax if (1) its gross receipts for the taxable year do not exceed \$600,000 and (2) the premiums received for the taxable year are greater than 60% of its gross receipts. In addition, both bills contain a provision that allows a property and casualty insurance company to elect to be taxed only on taxable investment income if the greater of its net written premiums or direct written premiums does not exceed \$1.89 million.

2. How Goes “Pay-As-You-Go” Provisions? Not Well

The Senate failed to pass a budget resolution because it did not provide for pay-as-you-go (“pay-go”) rules for tax as well as spending provisions. More recently, the House considered the Spending Control Act of 2004 (H.R. 3973) that would create “pay-go” rules for mandatory spending increases and provide discretionary spending caps, but would have provided no similar pay-go rules for tax cuts. Although an amendment to add pay-go rules for tax cuts failed, the vote on the Spending Control Act likewise failed.

POLICYHOLDER ISSUE

I.R.C. §§ 104 and 105 — IRS Rules on Includability of Employer-Provided Disability Benefits

The IRS ruled in Rev. Rul. 2004-55, 2004-26 I.R.B. 1081, that if an employer pays for disability coverage for an employee on an after-tax basis (i.e., the employer reports the employee’s allocable portion of the premium as includable in gross income), then any disability benefits received under an employer-provided plan are excludable from the gross income of the recipient, whether they are long-term or short-term disability benefits. Conversely, if the disability coverage is provided on a pre-tax basis (i.e., not reported as includable in gross income), then the benefits are includable in the gross income of the recipient. In the facts of the ruling, an employer provided a long-term disability plan, under which it paid each employee’s entire coverage premium on a pre-tax basis. In a later year, the plan was amended to

allow each eligible employee to elect to have the employer pay the entire premium on an after-tax basis. Based on the statute and regulations, the IRS held that benefits paid under the plan to employees who made the election to fund the plan on an after-tax basis would be excludable from income under I.R.C. § 104(a)(3); benefits paid to employees whose premiums were paid on a pre-tax basis would be includable under I.R.C. § 105(a). The ruling specifically concluded that the holdings applied equally to short-term disability benefits.

COMPANY ISSUES

1. I.R.C. § 864 — Proposed Regulations Issued on Stock Held by Foreign Insurers

The IRS issued REG-117307-04, a proposed regulation that provides that the exception to the asset-use test for stock shall not apply for purposes of determining whether the income, gain, or loss from portfolio stock held by foreign insurance companies constitutes effectively connected income. I.R.C. § 864(c)(2) provides rules for determining whether income received by a foreign corporation from sources within the United States, or gain or loss from the sale or exchange of capital assets from sources within the United States, is income effectively connected with the conduct of a trade or business in the United States. In making this determination, one factor taken into account is whether the income, gain or loss is derived from assets used in or held for use in the conduct of such trade or business (“the asset-use test”). Treas Reg. § 1.864-4(c)(2)(iii)(a) generally provides that stock of a corporation (whether domestic or foreign) is not an asset used in or held for use in the conduct of a trade or business in the United States for the purposes of determining the asset-use test. The newly proposed regulation states that this general rule, excluding stock from the asset-use test, does not apply to stock held by foreign insurers unless their ownership interest equals or exceeds 10% by vote or value. The purpose of the 10% threshold is to distinguish portfolio stock held to fund policyholder obligations and surplus requirements from investments in a subsidiary. The IRS has requested comments as to whether the 10% threshold is an appropriate standard for distinguishing portfolio investments from investments in a subsidiary.

2. I.R.C. §§ 6330, 6404 and 6601 — Tax Court Asserts Jurisdiction over Redetermination of Interest

The Tax Court, in Urbano v. Commissioner, 122 T.C. No. 22 (June 10, 2004), determined that it could review an IRS determination of the interest that accrued on a couple’s unpaid tax liabilities and determine whether the IRS is precluded from pursuing collection. In the facts of the case, the taxpayers reported negative total income and zero tax due on their joint return. They later amended their return to recognize gain on the sale of their home, which they offset against additional net operating losses. When the IRS audited this return, they made several adjustments, including interest. The taxpayers executed a Form 4549-CG, consenting to assessment and collection, and made full payment. The audit was then transferred to the IRS service center where it was determined that interest had been understated. When the IRS filed a tax lien related to the interest, the taxpayers requested a collection due process hearing. At the hearing, the taxpayers challenged the existence and amount of the interest and sought its abatement under I.R.C. § 6404. The Tax Court determined that, although the court generally lacks jurisdiction over issues related to I.R.C. § 6601 interest, jurisdiction exists to review the interest

determination given the court's jurisdiction to review the taxpayers' abatement claim. After determining it could hear the case, the Tax Court held that the interest redetermination was both correct and permissible and that the taxpayers were not entitled to abatement under I.R.C. § 6404.

3. IRS Will Soon Be Seeking Tax Workpapers

At a June 17th Practising Law Institute meeting in Los Angeles, the IRS announced that it would be asking taxpayers and attorneys for tax accrual workpapers for current year audits. While the IRS has acknowledged that such requests have been infrequent in the past, as part and parcel of its assault on tax shelters, the IRS will be making more requests shortly.

4. NAIC Postpones Implementation of Risk-Based Capital and Reserving Project for Variable Annuities with Guarantees

Regulators at the National Association of Insurance Commissioners ("NAIC") have postponed implementation of a risk-based capital and reserving project for variable annuities with guarantees until 2005. The implementation was apparently postponed because of concerns that state insurance departments may not have the resources to oversee results produced from the project. In addition, issues have been raised related to hedging – such as whether a commissioner should be allowed to disallow any hedging that is found not to be appropriate for capital relief and the proper treatment of hedging as it relates to risk-based capital and reserving.

**For comments or questions, or if you would like to receive the Tax Issues Summary via electronic mail, please contact Joseph A. Sergi at (202) 434-9172 or jsergi@scribnerhall.com
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