SCRIBNER, HALL & THOMPSON, LLP

SUITE 1050

1875 EYE STREET, N. W.

WASHINGTON, D. C. 20006-5409

(202) 331-8585

FAX (202) 331-2032

THOMAS C. THOMPSON, JR.
MARK H. KOVEY
STEPHEN P. DICKE
PETER H. WINSLOW
SUSAN J. HOTINE
BIRUTA P. KELLY
GREGORY K. OYLER
LORI J. BROWN
SAMUEL A. MITCHELL
JOSEPH A. SERGI

FRED C. SCRIBNER, JR. (1908-1994)
LEONARD W. HALL (1900-1979)

# TAX ISSUES SUMMARY

**July 30, 2004**

*HIGHLIGHTS:*

**2004-2005 Priority Guidance Plan Issued**

On July 26th, the IRS and Treasury released their 2004-2005 Priority Guidance Plan listing tax regulations and other administrative guidance expected to be published by June 30, 2005. They expect to continue the practice of updating and publishing the plan on a quarterly basis to reflect additional guidance topics on which guidance will be issued. The plan contains several items that should be of interest to insurance companies. See Legislation.

**I.R.C. §§ 871 and 1441 — Income Received by Non-Resident Aliens under Life Insurance and Annuity Contracts Issued by a Foreign Branch of a U.S. Insurer Is U.S.-Sourced Income**

On July 12th, the IRS issued Rev. Rul. 2004-75, 2004-31 I.R.B. 109, which concluded that income received by non-resident alien individuals under life insurance and annuity contracts issued by foreign branches of a U.S. life insurance company is U.S.-sourced income subject to the 30% tax and withholding of I.R.C. §§ 871(a) and 1441. See Policyholder Issues.

**I.R.C. § 6011 — IRS Provides Guidance on Newly-Issued Schedule M-3**

On July 7th, Treasury and the IRS released the final draft Form 1120 Schedule M-3 Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More, as well as Rev. Proc. 2004-45, 2004-31 I.R.B. 140, which provides guidance for coordinating the Schedule M-3 with the significant book/tax difference disclosure requirement in Treas. Reg. § 1.6011-4. Also, Treasury provided a separate news release (IR-2004-91 (July 7, 2004)) providing answers to several frequently asked questions, including whether insurance companies in a consolidated group have to file the Schedule M-3. Schedule M-3 will be required for tax years ending on or after December 31, 2004. See Company Issues.

## LEGISLATION

### 1. In General

Congress recessed for six weeks, leaving what might have been considered the "likely" tax bills undone. With a week to go, it looked as though the House and Senate had worked out a plan to pass a conference report on "the middle class tax cut" (which included an extension of the expanded 10% income tax bracket, the $1,000 child tax credit and marriage penalty relief) before the recess and to take up the ETI repeal and the JOBS bill just after Labor Day. The agreement (including an agreement on who would chair which conference) fell apart when the Administration refused to accept a middle class tax cut extension of less than five years. Now, House and Senate leaders will start from scratch in negotiating what portions of the pending tax legislation can be successfully conferenced and passed prior to adjourning in early October for the elections. (The Senate bill to repeal ETI and provide jobs continues to have a provision to suspend the application of I.R.C. § 815, and both the House and Senate bills have identical clarifying language for I.R.C. §§ 501(c)(15) and 831(b) affecting small property casualty insurers.)

Despite recent setbacks for other tax legislation, a bipartisan group of House members introduced The Retirement Security for Life Act of 2004 (H.R. 4849), which would amend I.R.C. § 72 to provide that 50% of lifetime annuity payments received by a taxpayer in a tax year is excluded from income, up to a maximum of $20,000 per year (this ceiling would increase annually with a cost-of-living adjustment beginning in 2006).

### 2. 2004-2005 Priority Guidance Plan Issued

On July 26th, the IRS and Treasury released their 2004-2005 Priority Guidance Plan listing tax regulations and other administrative guidance expected to be published by June 30, 2005. The plan contains several items that should be of interest to insurance companies. Under the specific category "Insurance Companies and Products," there are only three items.

- Final regulations under I.R.C. § 817 on life insurance and annuity contracts.
- Guidance on the application of the diversification look-through rule under I.R.C. § 817 to tiered investment companies.
- Guidance on 2001 CSO mortality tables.

However, there are more than a dozen other projects, under categories that apparently are not within the insurance branch's primary jurisdiction (or even that of the Associate Chief Counsel for Financial Institutions & Products), which could impact insurance companies not only from a tax perspective, but also a financial or market competition perspective.

- Final regulations under I.R.C. § 1502 regarding indebtedness to nonmembers that is traceable to intercompany obligations. (Consolidated Returns)
- Final regulations regarding taxable asset acquisitions and dispositions on insurance companies. (Corporations and their Shareholders)
- Guidance under I.R.C. § 402 on the valuation of life insurance distributed from qualified plans. (Retirement Benefits)
- Guidance under I.R.C. § 412 on mortality tables. (Retirement Benefits)
- Guidance on the value of term life insurance for split dollar and pension plans. (Executive Compensation, Health Care, Other Benefits)
- Guidance under I.R.C. § 79. (Executive Compensation, Health Care, Other Benefits)
- Revenue rulings on I.R.C. § 83(b) elections and on timing issues under I.R.C. § 83. (Executive Compensation, Health Care, Other Benefits)
- Guidance under I.R.C. §§ 419 and 419A. (Executive Compensation, Health Care, Other Benefits)
- Guidance under I.R.C. § 501(c)(15). (Exempt Organizations)
- Guidance under I.R.C. § 691 regarding income in respect of a decedent and deferred annuity contracts. (Gifts, Estates and Trusts)
- Final regulations on the treatment of portfolio stock in a U.S. insurance branch. (International)
- Guidance under I.R.C. § 1441. (International)
- Guidance on the treatment of certain financial products for withholding purposes. (International)
- Guidance on cross-border banking and insurance issues and on cross-border information reporting issues. (International)
- Update of Rev. Proc. 2004-23 regarding method of accounting changes for intangibles. (Tax Accounting)
- Guidance under I.R.C. § 468B regarding the tax treatment of a single-claimant qualified settlement fund and regulations under I.R.C. § 468B regarding certain escrow funds. (Tax Accounting)
- Guidance regarding information reporting under I.R.C. § 6041 for commissions paid to insurance agents and regulations under I.R.C. § 6045(f) regarding the reporting of gross proceeds to attorneys. (Tax Administration)

The IRS and Treasury expect to continue the practice of updating and publishing the plan on a quarterly basis to reflect additional guidance.

Comment: As diverse parts of the IRS start making rules that apply to insurance companies and their products, the insurance industry should take care to assure itself that consistent legal and economic analyses are being used in the development of any tax rules that may impact insurance companies and their products. It should not be assumed that the IRS and Treasury will do that on their own.

### 3. IRS is Looking at Investor-Owned Life Insurance

In a Senate Finance Committee hearing regarding whether tax-exempt organizations are abusing their status, Commissioner Mark Everson stated that the IRS is reviewing investor-owed life insurance. In these arrangements, a charity-funded trust sells fixed income security interests in that trust to institutional investors and uses the received funds to purchase immediate annuities on the lives of the charity's donors. The income from the annuities is then used to purchase life insurance on the same donors, with the charity receiving the difference in the annuity rates over the rates paid out for the life insurance. Life insurance agent associations are warning against involvement in these plans and, in conjunction with the American Council of Life Insurers, are working to oppose legislation that would loosen state insurable interest laws.

## POLICYHOLDER ISSUES

### 1. I.R.C. §§ 170 and 501(c) — Lack of Disclosure of Split-Dollar Arrangement Prohibits Deductibility of Contributions

In Addis v. Commissioner, No. 02-73628 (9th Cir. July 8, 2004), the Court of Appeals affirmed the Tax Court's ruling that contributions made to a nonprofit organization with the expectation that the contributions would be used to pay premiums for charitable split-dollar life insurance contracts are not deductible. In the facts of the case, the taxpayers entered into a death benefit option agreement with the National Heritage Foundation ("NHF"). Under the split-dollar arrangement, the taxpayers, through the Addis Family Trust, paid 10% of the annual premium and contributed an amount equal to the remaining 90% of the premium to NHF. Although not required to, NHF then opted to use the contribution to pay the remainder of the premium. Under the agreement, if NHF made the premium payments for 12 years, it would receive approximately 56% of the death benefit on the policy, while the remaining 44% would go to the Addis Family Trust. Receipts were provided to the taxpayers stating that NHF did not provide goods or services in return for the contribution, and the taxpayers deducted the amounts paid to NHF. The Tax Court determined that the receipts were inaccurate because the taxpayers expected to benefit substantially from their contributions to the funds to pay the premiums. Because the consideration received in return for the contribution was not disclosed, the applicable substantiation requirements of I.R.C. § 170(f)(8) and Treas. Reg. § 1.170A-13(f)(6) were not met, and the full amounts of the deductions were disallowed under I.R.C. § 170. The Court of Appeals affirmed the Tax Court's decision, holding that the taxpayers were not entitled to a charitable contribution deduction because the receipts substantiating the contributions failed to satisfy the disclosure requirements.

### 2. I.R.C. § 223 — IRS Issues Guidance on HSAs

In Notice 2004-50, 2004-33 I.R.B. ___, the IRS provides comprehensive guidance regarding the workings of Health Savings Accounts ("HSAs"). This guidance is in response to numerous public inquiries received by the IRS since the tax-free savings vehicles were established with the enactment of I.R.C. § 223 last December. In a question-and-answer format, the Notice offers guidance on: Eligible Individuals, High Deductible Health Plans ("HDHPs"), Preventive Care, Contributions, Distributions, Comparability, Rollovers, Cafeteria Plans and HSAs, Account Administration, Trustees and Custodians,

and Other Issues. Of note is a clarification specifying that coverage under employee assistance plans, disease management plans and wellness programs generally does not disqualify otherwise eligible individuals from contributing to an HSA so long as the programs do not provide significant benefits in the nature of medical care or treatment. Additionally, the Notice clarifies that employer contributions to an employee's HSA are deemed part of the employee's compensation, and the employer, therefore, is not permitted to recoup any portion of its contribution or to impose restrictions on the employee's abilities to take distributions from the HSA for nonqualified medical expenses. The Notice also contains detailed information regarding the inclusion of certain prescription drugs related to preventive care at lower deductibles. Finally, the Notice provides transition relief allowing individuals covered under health plans that would otherwise qualify as HDHPs, but for the lack of an express limit on out-of-pocket expenses, to be eligible to contribute to HSAs until January 1, 2005. Transition relief is also available to individuals covered under health plans that would qualify as HDHPs, but for annual deductibles to be satisfied over periods of more than 12 months, to be eligible to contribute to HSAs until January 1, 2006.

**3. I.R.C. §§ 871 and 1441 — Income Received by Non-Resident Aliens under Life Insurance and Annuity Contracts Issued by a Foreign Branch of a U.S. Insurer Is U.S.-Sourced Income**

On July 12th, the IRS issued Rev. Rul. 2004-75, 2004-31 I.R.B. 109, which concluded (1) income received by non-resident alien individuals ("policyholders") under life insurance and annuity contracts issued by foreign branches of a U.S. life insurance company is U.S.-sourced income subject to the 30% tax and withholding of I.R.C. §§ 871(a) and 1441 and (2) income received by bona fide residents of Puerto Rico (also "policyholders") under life insurance and annuity contracts issued by a Puerto Rican branch of a U.S. life insurance company is U.S.-sourced income that is subject to the tax imposed by I.R.C. § 1. The factual situation presented is that the policyholder owns an insurance or annuity product that has a cash value and either (a) withdraws an amount from the cash value of the life insurance or annuity contract that is includible in gross income, or (b) receives annuity payments under the annuity contract and some portion of those payments is includible in gross income. The facts of the ruling note that branches offer a wide range of insurance products that are life insurance and annuities for U.S. tax purposes, and there are no income tax treaties between the foreign country and the U.S. The facts state that the premiums are paid to a U.S. life insurance company by the policyholder, and the company invests the premiums received with respect to its life insurance and annuity contracts in both domestic and foreign income-producing assets, such as stocks and bonds. The ruling specifically says that it does not apply to amounts received under life insurance contracts by reason of the death of the insured and excludible from gross income under I.R.C. § 101. Having no source rule (U.S. vs. foreign) statutorily specified for income paid under life insurance or annuity contracts, the ruling states that such payments are analogous to interest, dividends and earnings on pension fund assets, which generally are sourced to the country of the obligor/payor/trust. Thus, the ruling concludes that income payments under life insurance and annuity contracts of a U.S. insurance company, even though the contracts are sold through a foreign branch, are U.S.-sourced income and subject to the tax and withholding of I.R.C. §§ 871(a) and 1441.

**COMPANY ISSUES**

**1. I.R.C. § 56 — Court of Appeals Affirms State Farm Ruling that Life-Nonlife Group Should Calculate AMT on a Consolidated Basis**

In an unpublished decision, the Court of Appeals for the Seventh Circuit affirmed the Tax Court's ruling that, in the context of a life-nonlife consolidated return, the alternative minimum tax ("AMT") book income adjustment should be made using a consolidated approach, with a single adjustment for the entire group. State Farm Mutual Auto. Ins. Co. v. Commissioner, No. 03-3761 (8th Cir. June 29, 2004), aff'g 199 T.C. 342 (2002). In the facts of the case, State Farm, an affiliated group made up of both life and nonlife insurance companies, filed a consolidated return. When it became subject to AMT, as a result of events generating a nonlife subgroup net operating loss carryback, State Farm calculated its book income adjustment on a consolidated basis. The Tax Court, having concluded that a subgroup approach was supported by neither statute nor regulations, determined that the language in both I.R.C. § 56(f) and the applicable regulations explicitly mandates that the consolidated approach be extended to all affiliates in a life-nonlife group. Thus, the IRS's argument that AMT should be computed at the subgroup level, with separate adjustments for each subgroup, was rejected. Additionally, the Tax Court noted that both the AMT and the consolidated return rules are silent on how combinations should be made and that using the subgroup approach to determine AMT should override the consolidated return regulations without express consent. The Court of Appeals affirmed the Tax Court's decision in an unpublished opinion.

**2. I.R.C. § 115 — Public Corporation Providing Last-Resort Property Insurance Ruled to be Tax-Exempt**

The IRS determined, in PLR 200427016 (Mar. 18, 2004), that a state-formed non profit public corporation providing last-resort insurance is an integral part of the state and would be considered tax-exempt under I.R.C. § 115. In the facts of the ruling, the state legislature formed a non profit public corporation to function exclusively to provide essential residential and commercial property insurance to applicants who are unable to procure insurance through the voluntary market. Under proposed legislation, the corporation would take over the operations of two plans that were previously formed to provide adequate insurance on property in the state. It is intended that the corporation's operations and income would be tax-exempt, and the corporation will have the authority to issue tax-exempt bonds or have such bonds issued on its behalf. The IRS has historically ruled that income earned by an enterprise that is an integral part of a state or its political subdivision is not taxable unless statutes specifically allow taxation of such income. To determine whether an enterprise is integral to the state, all facts and circumstances must be considered, including the state's degree of control over, and financial commitment to, the enterprise. In the facts presented, both these factors indicate that the corporation is an integral part of the state. Accordingly, its income would be exempt from federal income tax. Additionally, this ruling determines that debt obligations issued by the corporation would be considered debt obligations issued by or on behalf of the state under I.R.C. § 103, but did not determine whether interest on these obligations would be exempt from taxation.

**3. I.R.C. § 162 — Employer's Long-Term Care Insurance Payments May Be Deductible**

In information letter INFO 2004-0086 (June 24, 2004), the IRS explained when an employer may be able to deduct long-term care insurance premiums. In the facts at issue, the taxpayer receives payments from a partnership under a covenant not to compete. The partnership wishes instead to pay the taxpayer a salary and purchase long-term care insurance on the taxpayer's behalf. The taxpayer requested a ruling on whether the partnership would be allowed to deduct the premium payments on the long-term care insurance. Stating that the IRS does not issue private letter rulings on factual issues, they instead provided general information regarding the deductibility of the premium payments. While there are no specific requirements regarding a minimum salary or number of hours worked to determine whether compensation is reasonable in relation to the services rendered, the amounts an employer pays for an employee's long-term care premiums are deductible under I.R.C. § 162(a) as a form of compensation inasmuch as they are an amount that would ordinarily be paid for like services by like enterprises under like circumstances. Additionally, the IRS stated that an employer's payments for qualified long-term care are excludible from the employee's gross income and non business payments made for another person's long-term care coverage may be excluded as gifts from the payor to the insured person under I.R.C. § 102.

**4. I.R.C. § 404 — Health Insurers Are Allowed to Include Certain Health Care Providers' Incentive Payments in Discounted Unpaid Losses**

In Rev. Proc. 2004-41, 2004-30 I.R.B. 90, the IRS provides rules under which an insurance company that pays incentive or bonus payments to participating health care providers may include such payments in discounted unpaid losses, as well as procedures through which companies can obtain automatic consent to change their accounting method for such payments. Health care insurers and HMOs have programs under which a portion of a provider's fee is held back and paid if certain objectives are met and programs under which a bonus is paid to a provider if specified objectives are met. Despite the fact that these incentive/bonus payments are part of the cost of the health claims payable by the insurer, an underlying assumption of the ruling is that I.R.C. § 404(a) provides that these payments should be considered compensation deferred under a nonqualified plan and not deductible until the taxable year in which the amount is includible in the gross income of the recipient. Thus, in an effort to avoid a substantial administrative burden on both the IRS and insurers, Rev. Proc. 2004-41 provides an administrative exception that allows health insurance companies and HMOs to take deductions for incentive/bonus payments made to health care providers as part of discounted unpaid losses under I.R.C. § 832. The deduction is limited to payments that are made pursuant to a written agreement that is unilaterally established by the payor to encourage cost-efficient health care (and not, as a principal purpose, to defer income for the recipient); that are dependent on the attainment of pre-established performance goals for a performance period of not more than one year; that the payor records as a liability on its annual statement and includes in discounted unpaid losses under I.R.C. § 846; and that are made to a recipient that does not perform health care services as an employee or agent of the payor. The revenue procedure is effective for taxable years ending on or after December 31, 2003, and a company can obtain an automatic change in accounting method (without regard to otherwise applicable scope limitations) for either the first or second taxable year ending on or after December 31, 2003. The revenue procedure also provides audit protection for companies currently using an accounting method for incentive/bonus payments that is consistent with that provided in the procedure.

**5. I.R.C. §§ 816 and 832 — Statutory Reserves for Deferred Variable Annuities Computed Using Cash Surrender Values Are Considered Life Reserves**

In TAM 200428024 (Mar. 5, 2004), the IRS concluded that statutory reserves for deferred variable annuity contracts that are based on cash surrender values ("CSVs") qualify as properly computed or estimated life insurance reserves for purposes of determining whether the company is a life insurance company for tax purposes — at least to the extent the reserves equal the amount of the Commissioners Annuity Reserve Valuation Method ("CARVM") reserves required to be held under state law. In the facts considered, more than half of the total reserves were cash value amounts held in a separate account underlying deferred variable annuity contracts. The company did not compute the CARVM-required reserves for statutory purposes but used reserves based on CSVs, which were not computed or estimated on the basis of recognized mortality tables and assumed rates of interest. Because it knew that the CSV amounts in the aggregate exceeded the CARVM-required reserves for the contracts, the company knew that the CSV reserves satisfied the minimum reserve requirements of the Standard Valuation Law based on the CARVM method. The company argued that, because the CSV reserves were not computed on the basis of mortality and assumed rates of interest, they could not be taken into account as life insurance reserves for life insurance company qualification purposes. The IRS rejected this argument and concluded that, knowing that the CSVs would exceed the value of the CARVM-required reserves, the company effectively had calculated the reserves based on mortality tables and assumed rates of interest. Accordingly, the IRS concluded that the CSV reserves would qualify as life insurance reserves up to the amount as would be required if they had been computed under the CARVM.

**6. I.R.C. § 5891 — Final Regulations Issued on Reporting of Structured Settlement Factoring Excise Taxes**

The IRS issued final regulations (T.D. 9134, 2004-30 I.R.B. 70), effective July 8th, relating to the manner and method of reporting and paying the 40% excise tax imposed on any person who acquires structured settlement payment rights in a structured settlement factoring transaction. A structured settlement factoring transaction is defined as a transfer of structured settlement payment rights made for consideration, by means of sale, assignment, pledge, or other form of encumbrance or alienation. Individuals liable for the excise tax under I.R.C. § 5891 must report it on Form 8876, Excise Tax on Structured Settlement Factoring Transactions, within 90 days of receiving any structured settlement payment rights. The regulations also provide rules related to the IRS's authority to extend payment deadlines for any amount shown or required to be shown on the return. The regulations do not address the method of calculating the tax under I.R.C. § 5891, but the IRS stated that this may be addressed in future regulations. The final regulations do not make any substantive changes to the proposed regulations (REG-139768-02) that were issued in February 2003.

**7. I.R.C. § 6011 — IRS Provides Guidance on Newly-Issued Schedule M-3**

On July 7th, Treasury and the IRS released the final draft Form 1120 Schedule M-3 Net Income (Loss) Reconciliation for Corporations With Assets of $10 Million or More. On the same day, Rev. Proc. 2004-45, 2004-31 I.R.B. 140 was released, which provides guidance for coordinating the new Schedule

M-3 with the significant book/tax difference disclosure requirement of Treas. Reg. § 1.6011-4. The revenue procedure clarifies that companies that properly comply with the disclosure requirements on the Schedule M-3 and file it with the original tax return for years ending on or after December 31, 2004 will be deemed to have complied with the disclosure requirement for significant book/tax differences defined in Treas. Reg. § 1.6011-4(b)(6). It further provides that companies not required to file a Schedule M-3 can comply with the significant book/tax difference disclosure requirement by filling out the appropriate portions of the Schedule M-3, labeling it as an alternative disclosure under Rev. Proc. 2004-45, attaching it to the original filed return and sending a copy to the Office of Tax Shelter Analysis. Companies can also use this alternative disclosure procedure for significant book/tax differences in a year ending before December 31, 2004.

Of particular interest to insurance companies, Treasury provided a separate news release (IR-2004-91 (July 7, 2004)) providing answers to several frequently asked questions, including whether insurance companies in a consolidated group have to file the Schedule M-3. If the holding company files on a Form 1120L or 1120PC, no member of the group will be required to file the new Schedule M-3, regardless of whether any members of the group file a Form 1120. If the holding company files a Form 1120, however, all members of the group must file the Schedule M-3 regardless of whether the members file on a Form 1120L or 1120PC. The members that file on a Form 1120L or 1120PC have the option of filling out the entire Schedule M-3 or aggregating book tax differences on line 30 of Part II of the Schedule and separately disclosing each individual difference on a supporting schedule. Additionally, Treasury announced in the news release that the Schedule will be incorporated into Forms 1120L and 1120PC and other forms in the future.

**8. IRS Elaborates on Requests for Workpapers in Audits**

Recently, the IRS issued changes to the Internal Revenue Manual ("IRM") to elaborate on its policy on requesting workpapers in audits. Previously, in Announcement 2002-63, 2002-2 C.B. 72, the IRS stated it may request tax accrual workpapers in the course of examining any return filed after June 30, 2002 that claims any tax benefit arising out of a transaction that the IRS has determined to be a listed transaction. The new IRM provisions further explain this announcement, providing definitions for tax reconciliation workpapers, audit workpapers and tax accrual workpapers, and explaining the IRS policy and procedure for requesting each type. The IRS states it will continue to request tax reconciliation workpapers as a routine matter at the beginning of an examination. On the other hand, the IRM states that agents should apply the "unusual circumstances" standard in determining whether audit workpapers, tax accrual workpapers that do not involve a listed transaction, or tax accrual workpapers involving a listed transaction for returns filed on or before February 28, 2000 should be requested. "Unusual circumstances" exist under the following conditions: (1) a specific issue has been identified for which there exists a need for additional facts; (2) the IRS has sought from the taxpayer and available third parties all the facts known to them relating to the identified issue; and (3) the IRS has sought a supplementary analysis (not necessarily contained in the workpapers) of facts relating to the identified issue and has performed a reconciliation of the taxpayer's Schedule M-1 or M-3 as it pertains to the identified issue. Requests for tax accrual workpapers involving a listed transaction for returns filed after February 28, 2000, but before July 1, 2002, will be made if the taxpayer was required to disclose the listed transaction and failed to do so, and will be limited to the tax accrual workpapers for the years under

examination and to other years that may be directly relevant to the years under examination. Requests for tax accrual workpapers involving a properly disclosed listed transaction for returns filed on and after July 1, 2002 will be made for the year under examination and other years if directly relevant. However, if a listed transaction was not timely and properly disclosed, the IRS will routinely request all tax accrual workpapers for the year under examination or for other years that may be directly relevant to the years under examination. Finally, the IRS will request all tax accrual workpapers for the year under examination if it determines that the taxpayer claimed tax benefits from listed transactions and there are reported financial irregularities with respect to the taxpayer.

**9. Information on Credit Default Swaps Requested**

The IRS requested information on credit default swaps ("CDSs") in Notice 2004-52, 2004-32 I.R.B. ___, in response to requests for guidance on the appropriate tax treatment of the transactions and of the parties to the transaction. The Notice describes CDSs as contractual agreements in which one party purchases protection against the default of an obligor on a particular debt obligation. For the protection, the buyer typically pays either a single lump sum payment or periodical regular fees until the CDS has reached maturity or a defined credit event occurs. Upon the occurrence of a credit event, the protection seller pays the buyer an amount that reflects the loss in value on the obligation. Requests for guidance relate particularly to the treatment of payments from a U.S. buyer to a foreign protection seller, such as whether amounts paid by the buyer constitute income that is subject to I.R.C. § 1441 withholding or to the I.R.C. § 4371 excise tax on insurance premiums. To date, submissions and commentators have suggested that CDSs could be analogized to various derivative financial instruments, a financial guarantee or standby letter of credit, or an insurance contract. To facilitate its identification and analysis of the tax issues raised by such transactions, the IRS specifically requested information on the terms, pricing and accounting for CDSs, as well as general information on the market and market practice.

**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**
**Scribner, Hall & Thompson, LLP, website: www.scribnerhall.com**