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TAX ISSUES SUMMARY

August 31, 2004

HIGHLIGHTS:

I.R.C. § 807 — Net Surrender Value Reserves Must Be Reduced by a YRT Reserve Credit

In TAM 200435015 (May 11, 2004), the IRS concluded that Treas. Reg. § 1.801-4(a) (promulgated under prior law) has continuing applicability under present law and requires a life insurance company to reduce its life insurance reserves based on the net surrender value floor by the net value of the risks reinsured on a yearly renewable term ("YRT") basis. In arriving at this conclusion, the IRS reversed its position as explained in FSA 200123024 (Mar. 7, 2001). See Company Issues.

I.R.C. § 6621 — Federal Circuit Determines Interest Netting Is Available Only When Both Underpayment and Overpayment Periods Are Open

The Federal Circuit reversed the decision of the Court of Federal Claims and held that the Federal National Mortgage Association ("Fannie Mae") is not entitled to I.R.C. § 6621(d) interest netting when the statute of limitations is closed for one of the overlapping periods involved. Federal National Mortgage Association v. United States, No. 03-5162 (Fed. Cir. Aug. 12, 2004). The lower court had rejected the government's position based on Rev. Proc. 99-43, 1999-2 C.B. 579, which states that both periods in question must be open for interest netting to occur. Although the Federal Circuit agreed that Rev. Proc. 99-43 is not entitled to deference, it disagreed with the fact that the lower court did not examine whether the United States had waived sovereign immunity, a jurisdictional issue that neither the taxpayer nor the government had raised. The Federal Circuit determined that, because the case involved a time bar under the statute of limitations, sovereign immunity could only be waived to the extent the statute was clear; it concluded that, because the statute was ambiguous, the government had not waived sovereign immunity. See Company Issues.

LEGISLATION

In General

The legislative arena has been quiet for the month of August because of the Congressional recess and the Presidential Conventions. Although the staffs had been authorized to work informally on a possible agreement for the conference of the ETI repeal/JOBS bills, word is that there are still some major points that have to be worked out between the House and the Senate — like who will be chairman of the conference committee. Senator Grassley, Chairman of the Senate Finance Committee, is understood to be optimistic about working something out so a conference report can be adopted before the October recess for the elections; Chairman Thomas of the House Way and Means Committee is understood to be less optimistic. With limited legislative time left, the most important legislative task will be appropriations; now it looks like all the appropriations authorization will be considered in an omnibus appropriations bill.

POLICYHOLDER ISSUE

I.R.C. §§ 72(t) and 408 — IRS Considers Whether Annually Recalculated IRA Distributions Are Substantially Equal Periodic Payments

In three similar private letter rulings, the IRS considered whether annual distributions from Individual Retirement Accounts ("IRAs") would be substantially equal periodic payments and excepted from the 10% tax on premature distributions. In PLR 200432021 (May 11, 2004), the owners of two IRAs propose to calculate annual distributions by amortizing the IRA's account balance, as of December 31, over the IRA owner's life expectancy. The IRA owners propose to use the life expectancy as determined under the single life expectancy table of Treas. Reg. § 1.401(a)(9)-9, Q&A 1, and an interest rate equal to 120% of the federal mid-term rate as of December 31, and would recalculate the distribution amount annually using the same method. Similarly, in PLR 200432024 (May 11, 2004), the owner of a rollover IRA from a former employer's retirement plan proposes to receive annual distributions in a series of substantially equal periodic payments using the same method. Finally, in PLR 200432023 (May 11, 2004), the owner of a rollover IRA, received from his former employer's retirement plan, desires to receive annual distributions in an amount to be determined each year by dividing the IRA account balance, as of December 31, by an annuity factor. The annuity factor would equal the cost of an annual $1 per year life annuity begun at the IRA owner's age at the time of the first distribution, and is calculated using the mortality table in Rev. Rul. 2002-62 Appendix B, 2002-2 C.B. 710, and an interest rate equal to 120% of the federal mid-term rate as of December 31.

In examining these fact patterns, the IRS analyzed whether the distributions would be considered a series of substantially equal period payments under I.R.C. § 72(t)(2)(A)(iv), and thus avoid triggering the 10% tax on premature distributions under I.R.C. § 72(t)(1). Because there are no regulations on I.R.C. § 72(t), the IRS examined Notice 89-25, 1989-1 C.B. 662, as modified by Rev. Rul. 2002-62, which provides methods for determining substantially equal periodic payments. The IRS concluded that the IRA owners in both PLRs 200432021 and 200432024 propose to calculate their distributions using the

fixed amortization method described in Notice 89-25. Even though the payments will be recalculated each year, the IRS concluded that the life expectancies and interest rate used would not circumvent the requirements of I.R.C. § 72(t) and the pattern of distributions would fall within I.R.C. § 72(t)(2)(A)(iv). Consequently, the owners would be excepted from the 10% tax on premature distributions. In examining the facts under PLR 200432023, the IRS concluded that the taxpayer's annual method for calculating distributions would be the same as the fixed annuitization method presented in Rev. Rul. 2002-62 and would result in substantially equal periodic payments, excepting the distributions calculated in this manner from the I.R.C. § 72(t) tax on premature distributions.

COMPANY ISSUES

1. I.R.C. §§ 111 and 809 — Federal Circuit Affirms that Negative Differential Earnings Are Not Deductible in Later Years

The Court of Appeals for the Federal Circuit upheld the Court of Federal Claims decision that a mutual insurance company may not exclude future income by using a previously computed negative recomputed differential earnings rate in John Hancock Financial Services, Inc. v. United States, No. 03-5163 (Fed. Cir. Aug. 9, 2004). In the facts of the case, John Hancock argued that, under the tax benefit rule, it was entitled to exclude additions to its policyholder dividend deduction related to the negative recomputed differential earnings amount because the same data used to calculate its recomputed earnings differential amount for tax year 1986, from which it obtained no tax benefit, were also used as a basis for computing the insurance company's taxable income for tax years 1988 and 1989. The Court of Federal Claims rejected this argument, holding that the tax benefit rule did not apply because John Hancock had already received the benefit of the maximum deduction allowed by law in 1986 and because there was no recovery related to any loss John Hancock had experienced. In affirming the lower court's decision, the Federal Circuit concluded that because the taxpayer had failed to establish either that it was entitled to a deduction in 1986 or that there was any transactional nexus between the deduction from 1986 and the income it received in later years, it is not entitled to relief under the tax benefit rule.

2. I.R.C. §§ 265 and 291 — Bank Must Treat the Tax-Exempt Obligations and Interest Expense of Its Wholly-Owned Subsidiary as Its Own

In TAMs 200434021 (Mar. 12, 2004) and 200434029 (Mar. 26, 2004), the IRS determined that, for purposes of I.R.C. §§ 265(b), 291(a)(3) and 291(e)(1)(B), a bank must treat the tax-exempt obligations and interest expense of its wholly-owned subsidiary as its own. In TAM 200434021, a bank holding company owns a single commercial bank with a wholly-owned investment subsidiary located in a state without a corporate income tax. The commercial bank and the subsidiary file consolidated books for financial accounting and bank regulatory purposes. A five-member board of the subsidiary, made up of four officers of the holding company and the subsidiary's sole employee, establishes the subsidiary's investment policy and objectives and approves all portfolio transactions related to the subsidiary. In the same year, the subsidiary held tax-exempt bonds while the commercial bank incurred interest expense. For purposes of I.R.C. §§ 265(b), 291(a)(3) and 291(e)(1)(B), the commercial bank took into account only exempt obligations transferred to the subsidiary from the bank or those purchased by the subsidiary with cash received from the bank. The commercial bank did not take into account tax-exempt bonds

purchased by the subsidiary with reinvested earnings or treat all the subsidiary's exempt obligations as its own.

Similarly, in TAM 200434029, a holding company owns numerous banks, each of which wholly owns an investment subsidiary. All the subsidiaries have the same board of directors, made up of four officers of the holding company, which reviews all the subsidiaries' securities transactions. The subsidiaries have no employees and file consolidated books with the banks for financial accounting and bank regulatory purposes. For three years, each subsidiary and each bank held tax-exempt bonds and each bank incurred interest expense. The holding company did not treat all the subsidiaries' exempt obligations as those of the respective banks. Instead, only those obligations transferred to a subsidiary from its respective bank parent or those purchased by the subsidiary with cash from the bank were taken into account.

Under both sets of facts, the IRS concluded that the subsidiary's assets are controlled by the bank and held for its benefit. Consequently, each bank in a consolidated group must treat all tax-exempt obligations and interest expense of its wholly-owned subsidiary as its own for purposes of I.R.C. §§ 265(b), 291(a)(3), and 291(e)(1)(B).

3. I.R.C. § 368 — New Proposed Regulations Allow "Push-Ups" and "Drop-Downs" in Connection with Reorganizations

The IRS issued new proposed regulations (REG-130863-04) on the transfer of assets and stock to stockholders and subsidiaries following a reorganization and on whether such transactions qualify as tax-free reorganizations. These regulations expand on and replace previously proposed regulations (REG-165579-02) issued in March 2004. Under the previously proposed regulations, certain reorganizations followed by a transfer of stock of the parent corporation to a controlled subsidiary would qualify as tax-free reorganizations, allowing corporations to "drop down" acquired assets without adversely affecting the acquisition of such assets from qualifying as a tax-free reorganization. The newly-proposed regulations expand on REG-165579-02 by providing guidance on two situations. Under the new proposed regulations, a transaction that otherwise qualifies as a tax-free reorganization continues to qualify when acquired assets or stock are distributed "upstream" to a corporation or partnership after the reorganization. Additionally, if acquired assets are transferred to a partnership in which the transferor owns an interest, or to any party to the reorganization, after the reorganization, the transaction may still qualify as a tax-free reorganization if certain conditions are met. The regulations would apply to transactions occurring after the date the final regulations appear in the Federal Register. The deadline for comments and hearing requests regarding the proposed regulations is November 15, 2004.

4. I.R.C. § 807 — Net Surrender Value Reserves Must Be Reduced by a YRT Reserve Credit

In TAM 200435015 (May 11, 2004), the IRS concluded that Treas. Reg. § 1.801-4(a) (promulgated under prior law) has continuing applicability under present law and requires a life insurance company to reduce its life insurance reserves based on the net surrender value floor by the net value of

the risks reinsured on a yearly renewable term ("YRT") basis. In arriving at this conclusion, the IRS reversed its position as explained in FSA 200123024 (Mar. 7, 2001).

The regulation in question provides that reserves held by the company with respect to the net value of risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves. The regulation then gives a specific example that specifically involves YRT reinsurance. Although it also recognized that the regulation was promulgated to respond to concerns that reinsurance offsets should not be dependent upon whether the reinsurer is authorized, the TAM characterized the YRT example in the regulation as requiring that whatever amount is held for life insurance reserves on a contract has to be reduced for YRT reinsurance. The IRS said that the addition of net surrender value comparison to the computation of federal tax reserves in I.R.C. § 807(d)(1) does not void the regulatory requirement that the net value of risks reinsured on a YRT basis be taken into account in the computation of deductible life insurance reserves: "Because a comparison must be made to determine which is greater – the net surrender value or the Federally prescribed reserves – the net surrender value is, for this purpose, treated as a component of reserves." I.R.C. § 807(d)(1) determines the amount of life insurance reserves for a contract, regardless of the role played by the net surrender value, and, thus, Treas. Reg. § 1.801-4(a) requires reduction of life insurance reserves, even though the reserves are based on the net surrender value of the contract.

5. I.R.C. § 807 — District Court Grants Provident Summary Judgment on Refund Related to Open-Year Experience Rating Credits

A United States District Court in Tennessee has granted Provident Life and Accident Insurance Company's summary judgment motion on its refund suit involving an insurance reserve issue. Provident Life and Accident Ins. Co. v. United States, No. 1:01-CV-116 (E.D. Tenn. July 7, 2004). Provident reported premium stabilization reserves to reflect open-year experience rating credits on a group accident and health insurance program. The IRS disallowed deductions for reserve increases starting in 1986, contending that the open-year credits were unaccrued policyholder dividends. Provident filed a refund claim for tax year 1984, seeking reversal of a reserve decrease consistent with the IRS's treatment of reserve increases in later years. The Justice Department conceded the 1984 refund claim, but sought equitable recoupment of additional adjustments for closed tax years 1985 and 1986 to reflect unadjusted reserves for open-year credits in those years. Similar to mitigation, equitable recoupment allows a party to recoup barred tax assessments or refunds from a refund or assessment involving the "same item" in an open year. The court agreed with Provident's argument that the unadjusted year-end balances for 1985 and 1986 related to different experience from the 1984 year and therefore could not be the "same item" for purposes of equitable recoupment. The case demonstrates that the equitable recoupment doctrine will rarely apply to reserves, consistent with earlier IRS pronouncements that the mitigation provisions do not apply to inter-year life insurance reserve adjustments. (E.g., FSA 200143003 (May 11, 2001); GCM 39516 (Sept. 26, 1985).) The government has until September 7, 2004 to file a Notice of Appeal to the Sixth Circuit.

6. I.R.C. § 842(b) — Domestic Asset/Liability Percentages and Investment Yields for Foreign Insurers Released

In Rev. Proc. 2004-55, 2004-34 I.R.B. 343, the IRS released the domestic asset/liability percentages and domestic investment yields for foreign life and property and liability insurance companies to compute their minimum effectively connected net investment income for tax years beginning after December 31, 2002. The domestic asset/liability percentages are 125.9% for life companies and 170.9% for property and liability companies. The domestic investment yields are 6.8% and 5.0% for life companies and property and liability companies, respectively. Instructions for computing foreign companies' estimated tax liabilities are also provided.

7. I.R.C. § 951 — Guidance Issued on Determining a United States Shareholder's Pro Rata Share of a CFC's Subpart F Income

The IRS issued proposed regulations (REG-129771-04) updating existing guidance for determining a United States shareholder's pro rata share of the subpart F income of a controlled foreign corporation ("CFC"). The proposed regulations provide pro rata share rules for CFCs with a single class of stock, CFCs with more than one class of stock and CFCs for which the allocation of earnings and profits among multiple classes of stock depends on the exercise of discretion by a board of directors. For CFCs with a single class of stock, the regulations clarify that the shareholder's pro rata share is determined using the per share basis. For CFCs with multiple classes of stock, where the allocation of the earnings and profits among the difference classes of stock is not dependent on the decisions of the board of directors, the basic per share approach is retained. However, if the distribution of earnings among multiple classes of stock is dependent on the exercise of discretion by the board of directors, the earnings and profits are allocated to the classes of shares by their relative values on the hypothetical distribution date. There is a public hearing on the issue scheduled for November 18, 2004. Requests to speak, outlines of topics or comments are requested by November 4, 2004.

8. I.R.C. § 1502 — Relief from Deemed Waiver Rule Provided in Regulations on the Treatment of Acquired Subsidiary Loss Carryovers

The IRS issued temporary and proposed regulations making the application of the deemed waiver rule optional for consolidated groups. T.D. 9155; REG-129274-04. The deemed waiver rule, issued with the loss disallowance rules for duplicate losses on the sale of subsidiary stock, provides that the purchasing group will be deemed to have made an election to treat the subsidiary's loss carryovers, to the extent they were increased by an election by the prior group and expire upon the subsidiary's exit from the group, or would have been used to offset income, in a closed year, as expiring, for tax purposes, immediately before the subsidiary became a member of the purchasing group. Accordingly, no basis reduction under Treas. Reg. § 1.1502-32 would result from the expiration of, or failure to use, such losses. After receiving comments that the deemed wavier may deny the use of excess losses in cases where such a denial was not intended under the rules, the IRS and Treasury Department issued the new temporary and proposed regulations to provide relief from the deemed waiver rule of Treas. Reg. § 1.1502-32T(b)(4)(v) by making its application optional. The relief is applicable on and after

August 17, 2004, and groups may also apply the relief before August 18, 2004, and on and after March 7, 2002. Comments and hearing requests are due by November 16, 2004.

9. I.R.C. § 4251 — IRS Continues Assessment and Collection of Telephone Excise Tax; Issues Regulations on Reporting Failure to Pay

The IRS, in Notice 2004-57, 2004-35 I.R.B. 376, stated that it will continue to assess and collect the 3% communications excise tax under I.R.C. § 4251. The IRS has stated, in Rev. Rul. 79-404, 1979-2 C.B. 382, that a toll telephone service is subject to the excise tax even when charges vary only with the elapsed transmission time. There is a question as to whether this position is consistent with the statutory language in I.R.C. § 4252(b)(1) and two district courts have split on the issue and the decisions are currently on appeal. American Bankers Ins. Group v. United States, 308 F. Supp. 2d 1360 (S.D. Fla. Jan. 29, 2004); Office Max, Inc. v. United States, 309 F. Supp. 2d 984 (N.D. Ohio Feb. 13, 2004). On August 30th, the IRS issued Notice 2004-57, confirming that the IRS will continue to assess the excise tax and stating that failure to pay the assessed excise taxes may result in the imposition of penalties and interest. Taxpayers may file refund claims to preserve their claims for overpayment of excise taxes, but the IRS is not acting on the refund claims while awaiting the appellate courts' decisions. The IRS also issued temporary, proposed and final regulations (T.D. 9149; REG-163909-02) regarding the obligations of companies responsible for collecting the excise taxes to report the failure of their customers to pay the tax. The proposed, temporary and final regulations set a deadline for such reporting to be the due date of the company's return on which the tax would have been reported.

10. I.R.C. § 6621 — Federal Circuit Determines Interest Netting Is Available Only When Both Underpayment and Overpayment Periods Are Open

On August 12th, the Federal Circuit reversed the decision of the Court of Federal Claims and held that the Federal National Mortgage Association ("Fannie Mae") is not entitled to I.R.C. § 6621(d) interest netting when the statute of limitations is closed for one of the overlapping periods involved. Federal National Mortgage Association v. United States, No. 03-5162 (Fed. Cir. Aug. 12, 2004). In the facts of the case, Fannie Mae overpaid its taxes for 1974 and 1975, which were refunded in installments from 1994 through 1996; such years were open under the six-year statute of limitations applicable to overpayment interest. The overpayment periods overlapped with periods of underpayments for 1983 and 1986. There was a dispute between the parties as to whether the statutes of limitations on the underpayments were open on July 22, 1998.

The factual dispute regarding the statutes of limitations for the underpayments was not resolved by the Court of Federal Claims because it held that only one of the overlapping periods was required to be open in order for interest netting to apply. Because the parties agreed that the overpayment period was open on July 22, 1998, the lower court held that Fannie Mae would be entitled to interest netting. In holding for the taxpayer, the lower court rejected the government's position based on Rev. Proc. 99-43, 1999-2 C.B. 579, which states that both periods in question must be open for interest netting to occur. The lower court noted that Rev. Proc. 99-43 is not subject to deference under Chevron U.S.A. v. Natural Resources Defense Council, 467 U.S. 837 (1984) and relied on the rule of statutory construction under which doubt as to the meaning of a remedial statute should be interpreted broadly in favor of the taxpayer.

On appeal, the Federal Circuit agreed that Rev. Proc. 99-43 is not entitled to deference under Chevron. However, the appellate court disagreed with the lower court's decision because the lower court did not examine whether the United States had waived sovereign immunity, a jurisdictional issue that neither the taxpayer nor the government had raised. The appellate court determined that, because the case involved a time bar under the statute of limitations, sovereign immunity could only be waived to the extent the statute was clear; it concluded that I.R.C. § 6621 was not clear. The appellate court remanded the case to the lower court to determine whether the statute of limitations for the underpayment period had closed.

11. Additional Guidance Issued on Schedule M-3 Alternative Disclosure Procedures

On August 6th, the Department of Treasury issued a press release providing additional question-and-answer guidance regarding the new Schedule M-3 and alternative disclosure procedures under Rev. Proc. 2004-45, 2004-31 I.R.B. 140. Press Release JS-1848, U.S. Department of Treasury Office of Public Affairs, Treasury Answers Schedule M-3 Questions (Aug. 6, 2004). Last month, the IRS and Treasury issued the final draft Form 1120 Schedule M-3, Net Income (Loss) Reconciliation for Corporations With Assets of $10 Million or More, and Rev. Proc. 2004-45, which provides guidance for coordinating the new Schedule M-3 with the significant book/tax difference disclosure requirement of Treas. Reg. § 1.6011-4 and instructions on use of the new Schedule M-3 as an alternative method of complying with the disclosure requirement. The recently-issued press release contains interim guidance by providing the answers to eleven frequently-asked questions about the alternative disclosure procedures. The press release also states that differences greater than $10 million must be disclosed on the most recent version of the Schedule M-3 rather than a self-created schedule.

12. Protocol to Barbados Treaty Restricts Benefits Provisions

The Treasury Department released a signed Protocol to the 1984 Barbados-United States Income Tax Convention, which will provide a new limitation on benefits provision. Focusing on the denial of treaty benefits to companies that had "inverted," the limitation on benefits language in the Protocol is extremely restrictive. For example, under the Protocol, it will be difficult for a Barbados subsidiary of a United States corporation, which is publicly traded in the United States, to qualify for benefits under the treaty. Another example of the restrictive nature of the Protocol is its definition of an "insurance company," used to determine whether businesses qualify for treaty benefits under the active trade or business rules, which excludes reinsurance companies. The Protocol, signed on July 14th, will enter into force when ratified and will apply to all companies currently in existence (i.e., there is no grandfather provision).

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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