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## TAX ISSUES SUMMARY

September 30, 2004

### **HIGHLIGHTS:**

#### **I.R.C. §§ 871, 1441 and 7805(b) — Limited I.R.C. § 7805(b) Relief for Withholding on Income Paid to Non-Resident Aliens under Life Insurance and Annuities Issued by Foreign Branches**

In Rev. Rul. 2004-97, 2004-39 I.R.B. 517, the IRS provided limited I.R.C. § 7805(b) relief from the application of Rev. Rul. 2004-75. Specifically, Rev. Rul. 2004-97 stated that the earlier ruling's conclusion that the 30% withholding tax applied to income paid to non-resident alien policyholders under life insurance or annuity contracts issued out of foreign branches of U.S. life insurers would not be applied to payments made before 2005 if the payments were under contracts in existence prior to July 13, 2004. See Policyholder Issues.

#### **I.R.C. §§ 7702 and 7702A — IRS Issues Guidance in Light of Changes in Mortality Tables**

In Notice 2004-61, 2004-42 I.R.B. \_\_\_\_, as corrected, the IRS interprets the reasonable mortality charge requirements of I.R.C. § 7702(c)(3)(B)(i) in light of the recently adopted 2001 CSO tables becoming the new prevailing commissioners' standard tables during calendar year 2004. The Notice provides three safe harbors and transitional relief for complying with the reasonable mortality requirements in light the change in the CSO tables. See Policyholder Issues.

## LEGISLATION

### **In General**

Upon returning from the August recess, conferees for the middle-income taxpayer relief bills immediately started to work with the result that, on September 23<sup>rd</sup>, the House and Senate both passed the Working Families Tax Relief Act of 2004 (H.R. 1308), a \$146 billion package of tax breaks aimed primarily at middle-income taxpayers, which also contains extensions for 23 expiring business-related tax benefits. The bill provides extensions, through 2010, of the \$1,000-per-child tax credit, of marriage-penalty relief on an enhanced basis and of the expanded 10% income tax bracket, as well as providing some individual Alternative Minimum Tax ("AMT") relief through 2005, accelerating the 15% child tax

credit refundability to 2004 and providing a uniform definition of “child” for the Internal Revenue Code. The business-related tax provisions include extensions through 2005 of the research and development tax credit, the work opportunity tax credit and welfare-to-work tax credit.

With the Working Families Tax Relief Act of 2004 behind them, the House named conferees for the FSC/ETI repeal bills (otherwise known as the JOBS bills) this week, with some hope that a good bit of conference work can be accomplished and the bill passed by both the House and Senate before Congress’ October 8<sup>th</sup> adjournment. Though some speculators were pessimistic, odds for passage of the JOBS bills are now better than 50%.

## **POLICYHOLDER ISSUES**

### **1. I.R.C. §§ 871, 1441 and 7805(b) — Limited I.R.C. § 7805(b) Relief for Withholding on Income Paid to Non-Resident Aliens under Life Insurance and Annuities Issued by Foreign Branches**

In Rev. Rul. 2004-97, 2004-39 I.R.B. 517, the IRS provided limited I.R.C. § 7805(b) relief from the application of Rev. Rul. 2004-75, 2004-31 I.R.B. 109. Specifically, Rev. Rul. 2004-97 stated that the earlier ruling’s position that the 30% tax and withholding under I.R.C. §§ 871(a) and 1441 applied to income paid to non-resident alien policyholders (“NRAs”) under life insurance or annuity contracts issued out of foreign branches of U.S. life insurers would not be applied to payments made before 2005 if the payments were under contracts in existence prior to July 13, 2004. In issuing the second ruling, the IRS did not change its substantive tax conclusion of Rev. Rul. 2004-75 that income from cash value life insurance and annuity contracts is analogous to investment earnings like interest, dividends and earnings on pension funds, resulting in the conclusion that the income is sourced to the domicile of the obligor. Thus, income paid to NRAs under life insurance and annuity contracts issued by foreign branches of U.S. life insurance companies is U.S.-sourced income subject to 30% tax and withholding under I.R.C. §§ 871(a) and 1441. See July Tax Issues Summary, Policyholder Issues, No. 3.

### **2. I.R.C. §§ 7702 and 7702A — IRS Issues Guidance in Light of Changes in Mortality Tables**

In Notice 2004-61, 2004-42 I.R.B. \_\_\_\_, as corrected, the IRS interprets the reasonable mortality charge requirements of I.R.C. § 7702(c)(3)(B)(i) in light of recent changes in mortality tables. Under I.R.C. § 7702, the guideline single premium may be determined under I.R.C. § 7702(c) on the basis of reasonable mortality charges — that is, charges that meet the regulatory requirements and do not exceed those specified by the prevailing commissioners’ standard tables. I.R.C. § 807(d)(5) defines the prevailing commissioners’ standard tables as the most recent NAIC commissioners’ standard tables adopted by at least 26 states and provides a three-year transition rule for companies changing to the new tables for purposes of computing their reserves.

Notice 2004-61 notes that the NAIC commissioners’ standard ordinary tables (“CSO tables”) issued in 2001 became the prevailing commissioners’ standard tables during calendar year 2004 and provides three safe harbors for complying with the reasonable mortality requirements of I.R.C. § 7702(c)(3)(B)(i) in light of this change in the prevailing commissioners’ standard tables. First, the

interim rules described in Notice 88-128, 1988-2 C.B. 540 remain in effect, except as otherwise modified by Notice 2004-61. Second, in states that require or permit the use of the 1980 CSO tables at the time a contract is issued, the mortality charges will be treated as reasonable under I.R.C. § 7702(c)(3)(B)(i) for a contract issued in calendar years through 2008 if the charges do not exceed the 1980 CSO charges and do not exceed the mortality charges specified in a contract. Third, in states that require or permit the use of the 2001 CSO tables at the time a contract is issued, the mortality charges for a contract will be treated as reasonable if the mortality charges do not exceed the 2001 CSO charges and do not exceed the mortality charges specified in a contract. The Notice also provides guidelines regarding gender- and smoker-based variations of the CSO tables. The IRS requested comments, by January 10, 2005, on the application of I.R.C. § 7702(c)(3)(B)(i) and regarding guidance needed on issues not specifically addressed by either Notice 2004-61 or Notice 88-128.

## COMPANY ISSUES

### **1. I.R.C. §§ 263, 446 and 481 — IRS Modifies Guidance for Accounting Method Change Requests Related to Capitalization of Intangibles**

In Rev. Proc. 2004-57, 2004-38 I.R.B. 498, the IRS eases the requirements for certain taxpayers seeking to obtain automatic consent for accounting method changes under Treas. Reg. § 1.263(a)-5(n)(1). Earlier this year, the IRS released Rev. Proc. 2004-23, 2004-16 I.R.B. 785, which provided instructions for obtaining the Commissioner's automatic consent to change accounting methods under the final regulations on intangibles. Rev. Proc. 2004-23 contained a transition rule that provided automatic consent for a change in accounting method for taxpayers that filed a Form 3115 prior to April 26, 2004 that did not include all the information required by Rev. Proc. 2004-23. Under Rev. Proc. 2004-23, these taxpayers are not required to file a new Form 3115, so long as they timely file a written statement containing the information required under Rev. Proc. 2004-23. The written statement, along with the originally filed Form 3115, must be attached to the federal income tax return filed for the taxpayer's first taxable year ending on or after December 31, 2003, or for the taxpayer's second taxable year ending on or after December 31, 2003 if the first year's return included a Form 3115 and the I.R.C. § 481(a) adjustment was computed correctly on that return. Rev. Proc. 2004-57 eases this requirement by accepting, as timely, the accounting method change request for the taxpayer's second taxable year ending on or after December 31, 2003, regardless of whether the I.R.C. § 481(a) adjustment was computed correctly for the taxpayer's first taxable year ending on or after December 31, 2003, but only if computing the I.R.C. § 481(a) adjustment per Rev. Proc. 2004-23 will not result in a change in the taxable income reported on that return.

### **2. I.R.C. § 501(c)(15) — IRS to Scrutinize Property and Casualty Insurers Claiming to Be Tax Exempt**

In Notice 2004-64, 2004-41 I.R.B. \_\_\_\_, the IRS reminds taxpayers of recent amendments to I.R.C. § 501(c)(15) and states that it will continue to examine the eligibility of entities claiming to be tax-exempt property and casualty insurance companies under that section. Earlier this year, the Pension Funding Equity Act (Pub. L. No. 108-218) changed the eligibility requirements for small property and casualty insurance companies to be tax exempt under I.R.C. § 501(c)(15). To qualify for exemption under the new I.R.C. § 501(c)(15) provisions, a company must (a) be an insurance company for tax

purposes (i.e., more than half of the company's business must be the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies), (b) not be a life insurance company, and (c) have gross receipts for the taxable year that do not exceed \$600,000, but (d) have more than 50% of such gross receipts from premiums. In determining whether a company satisfies these requirements, the gross receipts and premiums of all members of a controlled group of corporations (including foreign and tax-exempt affiliates) are taken into account. Under a special rule, a mutual non-life insurer can qualify for exemption if its gross receipts for the taxable year do not exceed \$150,000 and its premiums are greater than 35% of its gross receipts, provided no employee or member of an employee's family is an employee of another I.R.C. § 501(c)(15) company. Additionally, there is a four-year transition rule which permits an insurance company in a receivership, liquidation or similar proceeding under the supervision of a state court on April 1, 2004 to qualify for exemption under the old law if the company was tax exempt under I.R.C. § 501(c)(15) (as in effect before 2004) for the taxable year including April 1, 2004. The application of the old law under this transition rule will cease for taxable years beginning after the earlier of the date the state proceeding ends or December 31, 2007. Notice 2004-64 states that the IRS will continue to scrutinize the exemption of entities under former I.R.C. § 501(c)(15) for any taxable year beginning prior to January 1, 2004 and the qualification of entities under the amended section for taxable years beginning after December 31, 2003.

**3. I.R.C. §§ 4251 and 4252 — Federal District Courts Continue to Divide over Applicability of Telephone Excise Tax**

Two more United States District Courts have held that the 3% telephone excise tax does not apply to long-distance telephone charges that do not vary by distance. National R.R. Passenger Corp. v. United States, No. 03-431 (RMC) (D.D.C. Sept. 20, 2004) and Fortis, Inc. v. United States, No. 03 Civ. 5137 (JGK) (S.D.N.Y. Sept. 16, 2004). The district courts in these cases held that the statutory language in I.R.C. § 4252 applies only to charges that vary by time and distance, as was the custom in 1965 when the law was enacted, and not to charges that vary only by elapsed time. It is expected that the government will appeal these latest cases. Previously, two other district courts have split on this issue (Office Max, Inc. v. United States, 309 F. Supp. 2d 984 (N.D. Ohio 2004) (tax does not apply) and American Bankers Insurance Group, Inc. v. United States, 308 F. Supp. 2d 1360 (S.D. Fla. 2004) (tax applies)) and both cases are currently on appeal. Last month, in Notice 2004-57, 2004-35 I.R.B. 376, the IRS stated that it will continue to assess and collect the excise tax and that taxpayers' failure to pay the tax to their carrier may result in the imposition of penalties and interest. While acknowledging that taxpayers may file claims for refund to preserve their claims, such claims will not be acted on until the pending appeals are decided. The IRS also released temporary, proposed regulations (T.D. 9149; REG-163409-02) detailing carriers' obligations to report the failure of their customers to pay the tax. See August Tax Issues Summary, Company Issues, No. 9. We recommend that companies file protective refund claims pending the outcome of the appellate courts' decisions and continue tracking the excise tax on telephone billing systems to support the claims.

**4. I.R.C. §§ 6011, 6111 and 6112 — IRS Determines PORC Transactions are No Longer Listed Transactions**

On September 24<sup>th</sup>, the IRS issued Notice 2004-65, 2004-41 I.R.B. \_\_\_\_, which removed certain reinsurance arrangements involving producer-owned reinsurance companies ("PORC transactions") from the tax shelter category of listed transactions. The IRS determined that problems associated with these

transactions were not as prevalent as originally thought. The IRS stated that it will continue to scrutinize PORC transactions that seek to shift income from taxpayers to entities purporting to be tax-exempt insurers. On the same day, the IRS released Notice 2004-67, 2004-41 I.R.B. \_\_\_\_\_, updating the listed transactions previously contained in Notice 2003-76, 2003-2 C.B. 1181 to include several transactions previously identified and to remove transactions previously withdrawn.

#### **5. I.R.C. § 7502 — Proposed Regulations Clarify Timely Mailing Treated as Timely Filing**

The IRS released proposed regulations (REG-138176-02) clarifying that, other than direct proof of actual delivery, a receipt from either registered or certified mail is the exclusive means to establish prima facie evidence of delivery to the IRS or the Tax Court, and the regulations also confirm that these methods of delivery will establish a presumption of delivery. I.R.C. § 7502 provides that, aside from direct proof of delivery, registered or certified mail receipts constitute evidence of delivery of documents to the IRS or the Tax Court. Such methods of filing provide a presumption of delivery and are considered filed as of the date of the postmark. In addition, Treas. Reg. § 901.7502-1 provides rules for taxpayers to follow to qualify for favorable treatment under I.R.C. § 7502. Federal appellate courts have conflicting opinions on whether the methods listed under I.R.C. § 7502 are the only acceptable means of evidence of delivery of such documents. Specifically, the courts have differed on whether a taxpayer may raise a presumption of delivery only in situations in which the taxpayer used registered or certified mail. The proposed regulations clarify that, other than direct proof of actual delivery, a receipt from registered or certified mail is the exclusive means to establish prima facie evidence of delivery. The IRS added that it may extend similar evidence of delivery rules to documents that are sent via private delivery services and seeks comments on whether such services should be treated as substantially equivalent to registered or certified mail. The proposed regulations are effective September 21, 2004, and comments and requests to speak at public hearings on the proposed regulations are due by December 20, 2004.

#### **6. IRS Issues Guidance Analyzing Effect of HIPAA on Informational Requests**

In a Chief Counsel notice (CC-2004-034 (Sept. 10, 2004)), the IRS outlines the effect of the Privacy Regulations of the Health Insurance Portability and Accountability Act of 1996 (“HIPAA”), 45 C.F.R. parts 160 and 164, on IRS requests for protected information (i.e., medical records and other individually identifiable health information) from an individual taxpayer or third party. Under the notice, to obtain protected information, the IRS must either obtain the consent of the individual taxpayer or show that the information requested is relevant and material to a legitimate law enforcement inquiry that is specific and limited in scope and where de-identified information is not sufficient. If a court case has been filed, the notice provides that the IRS must either obtain a court order or enter a stipulation or protective order with the individual taxpayer to obtain protected information. Finally, due to the lack of established guidelines in this area of law, the notice requires that all IRS referrals seeking court action to enforce a summons that requests protected information must be forwarded for pre-review to the Chief, Branch 3, Collection, Bankruptcy & Summonses Division, Associate Chief Counsel (Procedure & Administration).

Note: Insurance companies should be aware of this notice when evaluating informational requests from the IRS (such as IDRs and third-party summonses) related to information potentially protected by HIPAA.

## **7. IRS Comments on Financial Products Projects**

At a meeting of the D.C. Bar's Financial Products Committee on September 23<sup>rd</sup>, IRS attorneys discussed future guidance projects and emerging trends in financial products. Of interest to insurance companies, an IRS attorney commented on I.R.C. § 817 tiered investment companies, stating that the IRS plan to determine whether the look-through rules of I.R.C. § 817(h)(4) extend to subsidiary regulated investment companies ("RICs") of parent RICs. Also, he stated that the private placement partnership exception under Treas. Reg. § 1.817-5(f)(2)(i) likely will be revoked by the end of the year, per the proposed regulations issued last year. Additionally, during a discussion of how to characterize credit default swaps, another IRS attorney noted that the IRS has received few comments from the insurance industry on the topic, even though treating them as insurance is one of the possible characterizations (as opposed to treatment of them as options or notional principal contracts).

## **8. IRS Comments on Efficiency of Appeals Process**

The IRS discussed the Appeals process in the September 14<sup>th</sup> Tax Talk Today webcast, an event co-sponsored by the IRS. In the discussion, the IRS emphasized the increased speed with which Appeals cases are being resolved by contacting taxpayers more quickly and by using specialists rather than generalists in both the collection due process ("CDP") and offer in compromise ("OIC") cases. Since this approach has been implemented, taxpayers with CDP cases are generally contacted within 30 days, and although cases currently last an average of 250 days, the IRS expects to reach resolution, on average, within 120 days. OIC cases average 250 days, a significant drop from last year's 350-day average, while cases coming from Examination average about 300 days, which is about 25% faster than last year. Additionally, the IRS indicated in the webcast that it has increased its reliance on alternative dispute resolution tools, the most popular of which, the fast-track settlement option, has an 85% resolution rate. Fast-track mediation for both pre- and post-Appeals cases also boast high resolution rates, while the post-Appeals arbitration program has a low number of participants. The IRS also stated that, because most Appeals arise from the Small Business/Self-Employed division, that division's field compliance system will undergo a change in its management structure to improve efficiency and increase enforcement capabilities as of October 1<sup>st</sup>. Taxpayers, revenue agents and front-line managers are not expected to be affected by this change.

**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](mailto:jsergi@scribnerhall.com)  
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