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TAX ISSUES SUMMARY

October 29, 2004

HIGHLIGHT:

President Signs American Jobs Creation Act of 2004

On October 22nd, President Bush signed the American Jobs Creation Act of 2004, H.R. 4520 ("JOBS Act"), which repeals the foreign sales corporation/extraterritorial income exclusion ("FSC/ETI") provisions. The JOBS Act substantially modifies the rules governing international taxation and contains numerous provisions that affect domestic businesses. The JOBS Act contains several provisions of interest to insurance companies, including a two-year suspension of the Phase III tax, a clarification of the Treasury Secretary's authority under I.R.C. § 845, provisions that limit the deductions allocable to property used by I.R.C. § 501(c)(15) tax-exempt insurance companies and other exempt entities, provisions affecting nonqualified deferred compensation plans and provisions related to the calculation and utilization of foreign tax credits. The JOBS Act also contains several tax shelter provisions involving reporting requirements related to listed and reportable transactions. See Legislation.

LEGISLATION

1. President Signs American Jobs Creation Act of 2004

On October 22nd, President Bush signed the American Jobs Creation Act of 2004, H.R. 4520 ("JOBS Act"), a \$138 billion tax package that repeals the foreign sales corporation/extraterritorial income exclusion ("FSC/ETI") provisions. The JOBS Act adopts a reduced tax rate for domestic manufacturing activities, makes numerous changes to the system of international taxation and makes changes to other tax laws affecting domestic companies. Several specific and general provisions should be of particular interest to insurance companies.

- The JOBS Act creates a two-year suspension of the Phase III tax under I.R.C. § 815 for tax years beginning after December 31, 2004 and before January 1, 2007. Under this provision, amounts distributed to shareholders from the policyholder surplus account will not be subject to

tax. For purposes of this suspension period, the order in which distributions are deemed to be made is reversed, treating distributions as first being made out of the policyholder surplus account and then out of the shareholder surplus account.

- The JOBS Act amends I.R.C. § 845 to clarify that the Secretary of the Treasury has broad authority to allocate or re-characterize income, deductions, assets, reserves, credits, or make any other adjustment to reinsurance agreements between two related parties in order to reflect the proper source, character or amount of the item.
- New I.R.C. § 6603 allows a taxpayer to make a cash deposit with respect to disputable tax liabilities in order to suspend the running of interest on potential underpayments and provides that, upon written request by the taxpayer, such deposit will be returned with interest at the federal short-term rate. Any amount of a proposed deficiency in a 30-day letter is, by definition, a disputable tax liability for these purposes. Although the deposit will suspend the running of interest on potential underpayments, the return of the deposit is not a “refund” subject to all the refund tax procedures. It is important to note that the interest rate credited on deposits is lower than the amount credited on overpayments and that deposits will not be available for use in interest netting calculations.
- New I.R.C. § 409A imposes numerous requirements on non-qualified deferred compensation plans. If these requirements are not met, all compensation deferred under a plan is includible in a participant’s gross income to the extent the compensation is not subject to a substantial risk of forfeiture, and the participant must pay an additional tax in the amount of 20% of the amount required to be included in income, as well as interest at the underpayment rate plus 1%.
- The JOBS Act reduces the number of categories of income (“baskets”) used to calculate the foreign tax credit limitation from 9 to 2: a passive income basket and a general income basket. Financial services income, which contains income earned in the active conduct of insurance, is now treated as general limitation income.
- The JOBS Act amends the carryover periods for foreign tax credits, extending carryforward periods to ten years and reducing the carryback period to one year.
- The JOBS Act repeals the 90% limitation on the utilization of the foreign tax credit for purposes of the alternative minimum tax (“AMT”).

Finally, the JOBS Act adds several tax shelter provisions to the Code. Of particular importance are the increased penalties related to listed and reportable transactions.

- New I.R.C. § 6707A imposes a penalty for failure to disclose a reportable or listed transaction whether or not there is an underpayment of tax. The IRS Commissioner has non-reviewable discretion regarding whether to rescind the penalty if it is related to a reportable transaction; it is a strict-liability penalty if it is related to a listed transaction.

- The JOBS Act increases the accuracy-related penalty on reportable transactions that are not disclosed and severely limits taxpayers' ability to rely on a reasonable cause defense.
- The JOBS Act extends the statute of limitation on assessment with respect to undisclosed listed transactions.
- The JOBS Act contains various other provisions related to practice before the IRS, tax shelter promoters and disclosure requirements.

For a more detailed explanation of the tax shelter provisions in the JOBS Act, see our memorandum "Review of Tax Shelter Provisions in the American Jobs Creation Act of 2004," dated October 21, 2004.

2. Possible Lame Duck Session

In mid-November, Congress is expected to return for a short session focusing on three main priorities: an omnibus appropriations bill, legislation to raise the debt ceiling and leadership elections. It is unlikely there will be a vote on new business.

POLICYHOLDER ISSUES

1. I.R.C. §§ 72 and 1014 — IRS Permits a Step-Up in Basis for Old Deferred Fixed Annuity Contracts

In PLR 200439016 (May 27, 2004), the IRS determined that revoked Rev. Rul. 70-143, 1970-1 C.B. 167 governs the application of I.R.C. § 1014 in determining the basis of annuity contracts purchased prior to October 21, 1979 by a deceased annuitant. As a result, with respect to the decedent taxpayer ("Decedent"), income distributions from such contracts take into account a stepped-up basis, determined by the fair market value of the contract as of the date of the annuitant's death. In the facts of the ruling, Brother purchased two deferred fixed annuity contracts prior to October 21, 1979, under which the annuitant would be paid a monthly income starting at the maturity date. The contracts also stated that, if the annuitant died prior to the maturity date, the company would pay the designated beneficiary the current contract value as of the date of the annuitant's death. Brother designated himself as the owner and the annuitant of both contracts. On the first contract, Brother also designated himself as the primary beneficiary and Decedent as the contingent beneficiary. On the second contract, Brother designated his own estate as the primary beneficiary and listed no contingent beneficiary. Prior to the maturity date, Brother died. Under state law, Brother's entire estate was distributed to Decedent, his only surviving relative. Decedent then died prior to the maturity date. For the first annuity, payouts were made to Decedent's estate, as Decedent was the contingent beneficiary of the first annuity. For the second annuity, payouts were made to Brother's estate and subsequently allotted to Decedent's estate under state law. Because both contracts were purchased, and all payments to them were made, prior to

October 21, 1979, the IRS concluded that revoked Rev. Rul. 70-143 governs the application of I.R.C. § 1014 with respect to the annuities and that the bases of the contracts in Decedent's and Brother's estates are determined by the fair market values of the contracts at the date of Brother's death, or the alternate valuation date if so elected. The result reached in this ruling is surprising because the facts involved deferred fixed annuities and previously, the IRS had applied the analysis in Rev. Rul. 70-143 only to variable annuities.

2. I.R.C. §§ 1361 and 1362 — S Corporation's Split-Dollar Life Insurance Arrangements Would Not Create Second Class of Stock

The IRS, in PLR 200441023 (June 3, 2004), ruled that an S corporation's proposal to enter into a split-dollar life insurance arrangement would not create a second class of stock and the corporation would continue to qualify as an S corporation under I.R.C. §§ 1361 and 1362. In the facts of the ruling, an S corporation proposed to enter into split-dollar life insurance agreements with trusts established for a number of recipients. The recipients would be required to pay to the S corporation a portion of the premium for a policy insuring the joint lives of the recipients, and then the S corporation would pay the total premium. If the recipients failed to make a payment of their allocable portion, the payment of that portion to the insurer by the S corporation would be treated as a loan from the S corporation to the recipients. At the time of the death of the survivor of the recipients, the S corporation would be entitled to a portion of the proceeds equal to the amount of any outstanding loans, plus proceeds equal to the greater of the total amount of premiums paid by the S corporation or the cash surrender value of the policy.

The IRS considered whether the company would continue to qualify as an S corporation if it entered into these split-dollar arrangements. To qualify as an S corporation, a small business must, under I.R.C. § 1361, have only one class of stock. A corporation is treated as having one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation. The IRS concluded that Treas. Reg. § 1.1361-1(l)(2)(i) provides that commercial contracts, unless entered into to circumvent the one class of stock requirement, are not considered binding agreements related to distribution and liquidation proceedings. In this situation, the split-dollar agreements would neither alter the policyholders' rights to proceeds nor create a second class of stock, thus not preventing the company from qualifying as an S corporation.

3. I.R.C. § 817 — Direct and Indirect Investments of Separate Accounts in Tiered Investment Portfolios Qualify for the Look-Through Rule

In PLR 200443029 (June 28, 2004), the IRS ruled that, because the purchase of a variable contract is the only means by which to have access to the assets of a portfolio, neither direct purchase and ownership by insurance separate accounts nor indirect purchase and ownership by insurance separate accounts through an investment company available only to insurance separate accounts (i.e., a tiered portfolio or investment company arrangement) will affect the applicability of the look-through rule for purposes of satisfying the diversification requirements of I.R.C. § 817(h) for variable contracts, and the underlying assets of the portfolios are looked to for diversification purposes. In the facts of the ruling, three trusts each consist of several separate investment portfolios ("funds") that are regulated investment companies ("RICs") pursuant to I.R.C. § 851(g)(1). The RICs serve as investment options for variable

annuity contracts and variable life insurance policies and are sold only to separate accounts of insurance companies, making public access to the funds available solely through the purchase of variable contracts. The investment advisors that manage each of the RICs propose to implement fund-of-funds portfolios in which funds within a trust (“first-tier portfolios”) would be invested in shares of certain funds offered by other trusts (“second-tier portfolios”). Aside from providing an investment alternative, using this tiered structure would avoid the administrative costs that would be incurred were the first-tier portfolio to mirror the direct investments of the second-tier portfolio.

The IRS examined whether first-tier portfolios that meet the diversification requirements of I.R.C. § 817(h) would continue to do so if they invest in or acquire shares of second-tier portfolios. Based on the facts presented, the IRS concluded that the look-through rule would be applicable not only to a separate account’s direct investments in a first-tier portfolio on behalf of a variable contract, but also to its indirect investment in shares of a second-tier portfolio through the first-tier portfolio’s investment in a second-tier portfolio. Likewise, the separate accounts can continue to rely on the look-through rule for direct investments into the second-tier asset portfolios, even after investment in such portfolios by the first-tier portfolios. Additionally, the IRS determined that a variable contract would not fail the investor control requirements merely because a first-tier portfolio acquires or invests in a second-tier portfolio. This ruling is consistent with a number of items addressing I.R.C. § 817 that have been recently released by the IRS.

COMPANY ISSUES

1. I.R.C. § 162 — IRS Determines Certain Settlement Payments Are Not Deductible as Ordinary and Necessary Business Expenses

In TAM 200439042 (May 21, 2004), the IRS determined that certain payments made to settle lawsuits are not deductible as ordinary and necessary business expenses under I.R.C. § 162. In the facts of the ruling, four companies, each in different states, were organized as mutual insurance companies. One of the companies demutualized, becoming a publicly held company. The publicly held company subsequently merged with the three mutual companies, two of which were tax-exempt companies under I.R.C. § 501(c)(4), while the third was exempt under state law. The application of various state statutes resulted in the combination of the assets of all the organizations in one publicly held company. Lawsuits were then filed against the publicly held company by each mutual company’s state of domicile. The suits principally alleged that the assets acquired by the publicly held company were impressed with a charitable trust, related to the assets accumulated as a result of the companies’ tax exemptions and/or held for charitable purposes, and that the charitable assets were subject to a constructive trust. Settlement agreements were reached with each state whereby the publicly held company agreed to make payments that were substantially less than the amounts originally demanded by the lawsuits. The payments were made to three charitable foundations, created for each of the mutual companies as a repository for the settlement payments, and the publicly held company deducted the settlement payments on its federal income tax returns as ordinary and necessary business expenses.

In its analysis, the IRS commented that, although the settlement agreement stated the payments were made to avoid litigation and business interruption, as well as to protect the company’s goodwill and

business reputation, such reasoning is irrelevant in the determination of whether such payments are deductible. The payment demands in the various lawsuits were based on the allegation that the publicly held company, as successor to the various mutual companies, owed charitable trust obligations. Although the amount of the settlement payments were less than demanded in the lawsuits, the character of the payments remained the same, which the IRS noted was further supported by the fact that the settlement payments were made to the charitable foundations rather than to the plaintiffs in the lawsuits. Had the company paid the demanded amounts in full rather than contesting them in court, they would not have been deductible. The IRS determined that the payments by the publicly held company were in settlement of its charitable trust obligation (i.e., the transfer of charitable trust assets) and were not deductible as ordinary and necessary business expenses.

2. I.R.C. § 831 — Certain Captive Indemnification Arrangements Are Not Insurance

In CCA 200442031 (June 25, 2004), the IRS determined that proposed indemnification agreements between a captive insurance company and operating single-member limited liability companies (“SLLCs”) would not qualify as insurance contracts because they would lack the requisite risk distribution, given that the captive would be created by a multi-member limited liability company (“MLLC”) and MLLC would be the only member in each of the operating SLLCs. In the facts, MLLC provides professional services through branches that are not individually organized, incorporated, or legally separate. MLLC accounts for each branch separately and considers the operations to be autonomous and obtains insurance for the risks incurred by the operating branches. MLLC plans to restructure its operations, creating a SLLC for each location. MLLC would be the single member of each SLLC. In exchange for the ownership interests in the SLLCs, MLLC would transfer the assets, liabilities and operations of each branch from MLLC to the appropriate SLLC. For federal tax purposes, the SLLCs would not be recognized as entities separate from MLLC. As part of the restructuring, MLLC proposes to form a captive insurance company. The SLLCs would then enter into indemnification arrangements with the captive insurance company, with the maximum percentage of liability coverage provided to any SLLC not exceeding 15%. MLLC represents that the indemnification agreements would be valid insurance contracts for a valid non-tax business purpose.

In examining whether the indemnification agreements would constitute insurance contracts for tax purposes, a key factor to be considered is whether risk distribution is present, which requires that premiums be pooled such that an insured is not, in significant part, paying just for its own risks. Because the SLLCs would not be considered separate entities from MLLC for federal tax purposes, the indemnity agreements would be treated as being between MLLC and the captive insurance company. This would leave only one entity being insured through the captive insurance company, falling short of the risk distribution requirement and preventing the contracts from being considered insurance. Consequently, the captive insurance company also would not be considered an insurance company under I.R.C. § 831(a).

3. IRS Must Refund Failed Insurance Company’s Federal Tax Payment to Enable Payment of State Guaranty Fund Claims

In Greene v. United States, No. 96-169T (Fed. Cl. Oct. 7, 2004), the United States Court of Federal Claims determined that, under the authority of a state statute for determining the priority of claims

against an insolvent insurer, the IRS was required to refund federal income taxes in order to provide funds for the state's guaranty fund to cover policyholders' claims. In the facts of the case, a life insurance company filed a tax return showing a zero tax liability. The following year, the corporation failed to qualify as an insurance company. As a result, the corporation became liable for taxes related to its policyholder surplus account and was required to add the liabilities to the year at issue – that is, the last preceding tax year in which it qualified as a life insurance company. Before a payment was made on the liability, the corporation became insolvent. The state failed to rehabilitate the corporation. With the filing of the corporation's amended federal income tax return, an amount was paid to the IRS to cover a portion of the increased tax liability related to the policyholder surplus account. The corporation timely filed a second amended return, requesting a refund of the previously paid amount. In its claim for refund, the corporation stated that it was due a refund because its receivership had insufficient funds to satisfy claims of its policyholders, and claims of policyholders and the state's guaranty fund are senior in priority to claims of the IRS.

The Court of Federal Claims examined the McCarran-Ferguson Act, 15 U.S.C. § 1012, and related case law, which grant states the authority to govern the business of insurance, including the designation of administrative expenses and policyholders' claims to receive priority over those of the United States. Under relevant state law, policyholders' claims receive priority over those of the federal government. The court granted the corporation's motion for summary judgment, concluding that it would be a "perverse result" if payments to the state guaranty fund, created to protect the rights of policyholders, were not entitled to the same priority as payments for policyholders' claims. The court therefore determined that the corporation was entitled to a full refund of its payment.

4. Schedule M-3 Final Draft Released

The Department of Treasury and IRS issued the final draft version of Form 1120 Schedule M-3, Net Income (Loss) Reconciliation for Corporations With Assets of \$10 Million or More. Compared to the revised draft Schedule M-3 released in July, this final draft contains only minor changes on the reporting of gains and losses. Over the summer, the IRS also issued a press release and revenue procedure providing question-and-answer guidance on the use of Schedule M-3 and outlining guidance for coordinating the new Schedule M-3 with the significant book/tax difference disclosure requirement of Treas. Reg. § 1.6011-4. According to a press release from the Treasury, no further changes to the Schedule M-3 are anticipated, and the final version is expected to be released in December 2004.

**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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