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## TAX ISSUES SUMMARY

November 30, 2004

### ***HIGHLIGHTS:***

#### **I.R.C. § 807 — Company Not Allowed to Compute Minimum Guaranteed Death Benefit Tax Reserves Using an AG 34-Like Method Prior to Adoption of AG 34**

In TAM 200448046 (Aug. 30, 2004), the IRS concluded that, prior to the adoption of Actuarial Guideline 34 (“AG 34”) by the NAIC in 1997, a life insurance company could not compute a reserve for minimum guaranteed death benefits (“MGDBs”) for variable annuity contracts by using a deemed drop in asset value, rather than the actual asset value. It was admitted that the accepted methodology for computing MGDB reserves prior to the adoption of AG 34 was by valuing the assets at their current value, without any drop in asset value. The IRS concluded that, in the absence of something being addressed by CARVM, the company was required to use the prevailing state practice or interpretation of CARVM. Accordingly, the company was not allowed to use a drop-in-asset-value assumption prior to that being prescribed by the NAIC when it adopted AG 34. See Company Issues.

#### **I.R.C. §§ 6011 and 6111 — IRS Issues Interim Guidance on Tax Shelters, Material Advisors and Reportable Transactions**

On November 16<sup>th</sup>, the IRS released guidance on the new disclosure requirements for material advisors and participants in reportable transactions. The new disclosure provisions under the American Jobs Creation Act of 2004, Pub. L. No. 108-357 (“Jobs Act”) include: penalties for failure of a material advisor to file an information return regarding a reportable transaction; penalties for failure of a material advisor to produce a list of investors upon request of the IRS; and penalties for failure of a participant to disclose a reportable transaction. The new guidance includes Notice 2004-80, 2004-50 I.R.B. \_\_\_\_, which provides interim rules for the new information reporting and list maintenance provisions to be effective until the IRS has a chance to issue regulations to implement the Jobs Act changes. Also, the IRS released four revenue procedures that narrow the reporting requirements on participants and material advisors related to four categories of reportable transactions. See Company Issues.

## LEGISLATION

### In General

After the elections, Congress returned for a lame duck session to take care of a few necessary items — a vote to raise the debt ceiling, passage of homeland security legislation to implement recommendations of the 9/11 Commission and passage of an omnibus bill for fiscal-year 2005 appropriations. Congress voted to raise the debt ceiling and passed a continuing resolution to fund the government until December 8<sup>th</sup>. Congress is expected to return for a post-Thanksgiving vote on the omnibus appropriations bill.

On November 19<sup>th</sup>, the Tax Technical Corrections Act of 2004 was introduced in both the Senate and the House (S. 3019, by Senate Finance Chairman Grassley and Senator Baucus; H.R. 5395, by Ways and Means Chairman Thomas). Although the primary focus of the technical correction legislation is the Jobs Act (specifically, the provisions dealing with the repatriation of foreign dividends and nonqualified deferred compensation), the bills also have a number of conforming and clerical amendments to the Working Families Relief Act of 2004, the Jobs and Growth Tax Relief Reconciliation Act of 2003, the Trade Act of 2002, and the Taxpayer Relief Act of 1997. Chairman Thomas has asked the public to review the technical correction legislation and provide written comments for the record.

## POLICYHOLDER ISSUES

### 1. **I.R.C. §§ 106 and 152 — Amended Definition of Dependent in I.R.C. § 152 Does Not Apply for Purposes of Employer-Provided Medical Care**

In Notice 2004-79, 2004-49 I.R.B. \_\_\_\_, the IRS determined that a change to the definition of dependent under I.R.C. § 152 does not apply when determining whether someone is a dependent for purposes of I.R.C. § 106 and until regulations under I.R.C. § 106 are amended accordingly, taxpayers can rely on the Notice. I.R.C. § 106(a) provides for the deductibility of contributions an employer makes to accident or health plans for employees, along with their spouses and dependents. Treas. Reg. § 1.106-1, which contains the definition of dependent for purposes of I.R.C. § 106, currently cross-references the I.R.C. § 152 definition, which was substantially narrowed in the Working Families Tax Relief Act (Pub. L. No. 108-311). The Act also amended I.R.C. § 105(b) to retain the pre-Act definition for purposes of determining the deductibility of employer-provided medical care reimbursements. Consequently, in Notice 2004-79, the IRS concluded that the specific change to I.R.C. § 105 shows that Congress did not intend to change the definition of dependent for purposes of employer-provided health plans and that the pre-Act definition of dependent for purposes of I.R.C. § 106 should be retained. Additionally, the IRS stated that Treas. Reg. § 1.106-1 will be amended to conform to the definition in I.R.C. § 105 and, until such an amendment is made, taxpayers can rely on Notice 2004-79.

**2. I.R.C. § 403 — Decedent's Interest in Qualified Plan Eligible for Rollover into Sole Beneficiary's IRA**

In PLR 200444032 (Aug. 5, 2004), the IRS concluded that the distribution of a decedent's interest in an I.R.C. § 403(b) plan to a decedent's estate may be rolled over into an individual retirement account ("IRA") owned by the estate's sole beneficiary. In the facts of the ruling, an individual ("decedent") contributed to a qualified plan, under I.R.C. § 403(b), and listed his estate as the beneficiary of his interest in the plan. Upon decedent's death, the proceeds of his interest in the plan were distributed to his estate and, pursuant to decedent's will, were subsequently distributed to his spouse in her capacity as the sole beneficiary of the estate. Within 60 days of receipt of the proceeds, the spouse intends to rollover the proceeds into an IRA that will be set up and maintained in her name. Distributions transferred directly from the decedent to the spouse are eligible for a tax-free rollover into an IRA, and, as a general rule, when distributions pass through a third party such as an estate before being distributed to the spouse, the assets are ineligible for such a rollover. The IRS considered whether such a rollover would be allowable and IRS determined that, under the facts presented, this general rule would not apply because the spouse has complete control over the proceeds of decedent's interest in the plan, and the spouse is eligible to rollover the distribution into an IRA.

**3. I.R.C. § 264 — Wal-Mart Brings Suit for COLI Policy**

On November 4<sup>th</sup>, the Supreme Court for the State of Delaware determined that Wal-Mart was not time-barred from pursuing its action against insurance companies and brokers for losses related to disallowed deductions resulting from the corporate-owned life insurance ("COLI") plan it purchased in 1993. Wal-Mart Stores, Inc. v. AIG Life Ins. Co., No. 126,2004 (Del. Nov. 4, 2004). Wal-Mart filed a \$150 million suit against several insurance companies, stating that they had not properly informed Wal-Mart of the tax-related and "insurable interest" risks involved in the COLI transactions, and is seeking restitution. In December 2002, a lower court dismissed the case, stating that Wal-Mart's claims were time-barred because the case commenced after the expiration of the three-year statute of limitations under Delaware law and that the statute was not tolled because Wal-Mart was put on notice that the IRS was challenging COLI transactions through various IRS technical advice memoranda and newspaper articles. The Supreme Court of Delaware reinstated the case, holding that the lower court erred in deciding that the statute was not tolled. The court determined that the TAMs and articles were not properly placed before the court and should not have been considered. Even if they were considered, Wal-Mart would not have been put on notice until September 3, 1999 and, the court added, neither the TAMs nor the articles were sufficient to alert Wal-Mart to any claims as to the insurable interest issue. As a result, Wal-Mart's action was timely filed and the case will commence.

## COMPANY ISSUES

### 1. **I.R.C. § 351 — Assumption Reinsurance Transaction Would Qualify as Constructive Exchange Preceding Sale of Transferor Charter and Licenses**

In PLR 200447004 (July 27, 2004), the IRS determined that transfers in a combination coinsurance and assumption reinsurance transaction would qualify under I.R.C. § 351 as a transfer of the life insurance business in constructive exchange for additional stock of a controlled subsidiary. In the facts of the ruling, a holding company (“Parent”) is a wholly-owned member of a life/non-life consolidated group. Parent wholly owns a life insurance company (“Target”), which in turn wholly owns another life insurance company (“Subsidiary”). Target and Subsidiary join in filing a life/life consolidated return. In a proposed three-step transaction, Target would transfer assets, subject to liabilities, to Subsidiary in a constructive exchange. The two companies would enter into combination reinsurance agreements whereby Subsidiary would assume Target’s liabilities under its insurance and annuity contracts through 100% coinsurance and assumption reinsurance agreements. The coinsurance would stay in effect only until regulatory approvals or policyholder consents are received to allow novation of the transferred contracts by Subsidiary. Although Target would continue to make contributions to Subsidiary in the form of cash and assets, it would hold no continuing obligations to its policyholders, although the obligations to contract holders who do not consent to novation presumably would remain in Target. In the second part of the transaction, Target would liquidate as a preliminary step for Parent to sell the Target stock in a “save-the-charter” transaction. Other than the minimum required capital under certain state laws, all of Target’s remaining assets would be transferred to Parent, including the stock of Subsidiary. Parent would assume all of Target’s liabilities that were not transferred to Subsidiary in step one. In the final step of the transaction, the stock of Target would be sold by Parent to an unrelated corporation (“Purchaser”), and Parent and Purchaser would make joint I.R.C. § 338(h)(10) elections to treat the stock sale as a deemed asset sale.

The IRS concluded, based on the taxpayer’s representations and applying Rev. Rul. 94-45, 1994-2 C.B. 39, that the transaction in the first step would qualify under I.R.C. § 351 as a tax-free transfer of assets by Target in constructive exchange for Subsidiary stock and the assumption of the transferred liabilities by Subsidiary. The treatment of the assets, reserves, premiums and the policies under the first step of the proposed transaction would also be governed by Rev. Rul. 94-45. The IRS also concluded that the transaction would not affect the date on which each life and annuity contract of Target was issued, entered into, purchased, or came into existence for tax purposes. As to the other steps of the transaction, the IRS concluded that, provided a timely I.R.C. § 338(h)(10) election is made, Target would be treated as having made a deemed sale of assets, except those actually transferred to Parent or Subsidiary, and gain and loss from the deemed asset sale would be included on Target’s federal income tax return.

### 2. **I.R.C. § 807 — Company Not Allowed to Compute Minimum Guaranteed Death Benefit Tax Reserves Using an AG 34-Like Method Prior to Adoption of AG 34**

In TAM 200448046 (Aug. 30, 2004), the IRS concluded that, prior to the adoption of Actuarial Guideline 34 (“AG 34”) by the NAIC in 1997, a life insurance company could not compute a reserve for minimum guaranteed death benefits (“MGDBs”) for variable annuity contracts by using a deemed drop in

asset value, rather than the actual asset value. Prior to the taxable year in question, the insurance company had established MGDB reserves, and reported them in its annual statement “blue book,” when the account value for a deferred variable annuity dropped below the MGDB. Connecticut’s Insurance Department advised companies licensed to do business in that state that it was adopting a new requirement for computing reserves for non-incidental death benefits (i.e., MGDBs in excess of the greater of the sum of the premiums or the account value) involving an assumption that, in computing these reserves, the account value of the contracts is reduced by a deemed one-third drop in asset value (regardless of the type of assets supporting the contract’s account value). However, apart from Connecticut, other states had no such rule until the NAIC adopted AG 34 for valuing MGDBs in 1997. AG 34 was effective for years beginning in 1998, for statutory purposes, for all contracts issued on or after January 1, 1981. By comparison with Connecticut’s requirement, AG 34 is less conservative, requiring drop-in-value assumptions from 2.5% to 14% (depending on the type of assets supporting the account) and also allowing assumptions that there would be subsequent recoveries based on net assumed returns at rates from 6.5% to 14% (depending on the type of assets supporting the account). It was admitted that the accepted methodology for computing MGDB reserves prior to the adoption of AG 34 was by valuing the assets at their current value, without any drop in asset value.

The IRS concluded that, in the absence of something being addressed by CARVM, the company was required to use the prevailing state practice or interpretation of CARVM, which was not the reserve requirements prescribed by Connecticut. Accordingly, the company was not allowed to use a drop-in-asset-value assumption prior to that being prescribed by the NAIC when it adopted AG 34. The TAM distinguished TAM 200108002 (Oct. 24, 2000), which had allowed a company to use a graded interest rate assumption for its CARVM computation prior to such an assumption being recognized by the NAIC in Actuarial Guideline IX-B. Whereas the IRS said that the taxpayer’s reserve method in TAM 200108002 “resulted in a minimum reserve and was determined to be consistent with CARVM and NAIC Guideline IX-B,” the IRS found the situation in TAM 200448046 to be “diametrically opposite” because the company’s use of “the extremely conservative method of Connecticut is neither the CARVM prescribed by the NAIC nor the prevailing state practice or interpretation of CARVM.” Its also noted that the NAIC had expressly rejected Connecticut’s method as arbitrary and overly conservative when AG 34 was being developed.

### **3. I.R.C. §§ 832 and 846 — 2004 Discount Factors for Unpaid Losses and Estimated Salvage Released**

On November 17<sup>th</sup>, the IRS issued Rev. Proc. 2004-69, 2004-49 I.R.B. \_\_\_\_, which provides loss payment patterns and discount factors for the computation of discounted unpaid losses under I.R.C. § 846 for the 2004 accident year. The IRS also released salvage discount factors for the 2004 accident year, to be used for computing the discounted estimated salvage recoverable under I.R.C. § 832, in Rev. Proc. 2004-70, 2004-49 I.R.B. \_\_\_\_.

### **4. I.R.C. §§ 6011 and 6111 — IRS Issues Guidance on Definition of Material Advisor**

On November 16<sup>th</sup>, the IRS released Notice 2004-80, 2004-50 I.R.B. \_\_\_\_, which provides interim rules for the new reporting and list maintenance provisions to be effective until the IRS has a chance to issue regulations to implement the change made by the Jobs Act. The IRS and Treasury have announced

their intention to issue regulations related to the disclosure requirements in the Jobs Act. Until that time, the IRS provided interim rules in Notice 2004-80, which clarifies the requirements for material advisors by providing definitions for key terms, specifying the proper forms and filing due dates and outlining the list maintenance obligations of material advisors. Notice 2004-80 specifies that, for purposes of the newly-enacted I.R.C. § 6111(a), a “reportable transaction” is defined in Treas. Reg. § 1.6011-4(b), which provides six categories of reportable transactions. In addition, the rules in Reg. § 301.6112-1(b)(2) (defining transactions with potential for significant tax avoidance) and Reg. § 301.6112-1(c)(2) (defining material advisor) will generally apply for determining whether a transaction is a “reportable transaction” with regard to a material advisor. In essence, the IRS is utilizing existing regulations to provide interim guidelines. This is significant because the Jobs Act could be read more broadly than the existing regulations.

The Notice also requires material advisors to use existing Form 8264, Application for Registration of a Tax Shelter, to report reportable transactions until the IRS has time to revise or replace the form. This form is due within 30 days after the person becomes a material advisor. The Notice provides a transitional rule requiring the filing on or before February 1, 2005 for persons that become material advisors after October 22, 2004 (the date of enactment of the Jobs Act) but on or before December 31, 2004. Also, if the material advisor registered the tax shelter under former I.R.C. § 6111 prior to October 22, 2004, that registration may substitute for having to file Form 8624. Finally, Notice 2004-80 provides that the existing list maintenance requirements in Reg. § 301.6112-1 will apply to the list maintenance requirements imposed by the Jobs Act.

#### **5. I.R.C. §§ 6011 and 6111 — IRS Narrows Requirements on Reportable Transactions**

On November 16<sup>th</sup>, the IRS issued four revenue procedures that eliminate certain specifically identified transactions as reportable transactions. These procedures apply to the designation of the transactions as reportable and will affect the requirements of both material advisors and participants. Guidance has been issued on the following types of reportable transactions: (a) transactions with contractual protections (Rev. Proc. 2004-65, 2004-50 I.R.B. \_\_\_); (b) loss transactions (Rev. Proc. 2004-66, 2004-50 I.R.B. \_\_\_, which supercedes prior guidance on loss transactions in Rev. Proc. 2003-24, 2003-1 C.B. 599); (c) transactions with significant book-tax differences (Rev. Proc. 2004-67, 2004-50 I.R.B. \_\_\_, which supercedes guidance on book-tax differences in Rev. Proc. 2003-25, 2003-1 C.B. 601); and (d) transactions with brief asset holding periods (Rev. Proc. 2004-68, 2004-50 I.R.B. \_\_\_). The IRS cautioned that some transactions may still be reportable under other provisions. It is important to note that Rev. Proc. 2004-67 excludes several insurance items from the determination of whether there is a significant book-tax difference, including: the accounting for inside buildup, death benefits or cash surrender value of life insurance or annuity contracts; the calculation of insurance reserves; and the capitalization of policy acquisition expenses. The guidance is effective November 16, 2004, for transactions entered into after December 31, 2002.

#### **6. IRS Announces Package Audit Program Targeting Executive Compensation**

On November 5<sup>th</sup>, at an American Bar Association meeting, an IRS official discussed the Large and Mid-Size Business Division’s new “package audit” program, targeting seven compliance areas of executive compensation. The new program identifies, as audit issues, seven of the eight issues targeted

in the executive compensation pilot program originally launched by the IRS and explains to auditors how to audit the issues. The compliance areas that are targeted are: whether the timing of employer deductions and employee recognition of nonqualified deferred compensation are matched; whether stock-based compensation requirements are met; whether, under the \$1 million cap on deduction of I.R.C. § 162(m), performance goals are changing mid-stream, or compensation is being paid and deducted when goals are not met; whether fringe benefits (e.g., spousal travel, the use of company aircraft, the treatment of consulting fees paid to former executives, and loans to executives to buy stock) are accounted for appropriately; whether there are stock options transferred to family limited partnerships; whether there are excess parachute payments under I.R.C. § 280G; and whether split dollar life insurance is being accounted for appropriately. While the IRS's Small Business/Self-Employed division continues to look at offshore employee leasing, the eighth compliance area in the pilot program, the issue will not be examined by LMSB.

**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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