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TAX ISSUES SUMMARY

January 31, 2005

HIGHLIGHTS:

Options to Improve Tax Compliance and Reform Tax Expenditures — A List of "Revenue Raisers" Proposed by the Staff of the Joint Committee on Taxation

On January 27th, the staff of the Joint Committee on Taxation issued a report on "Options to Improve Tax Compliance and Reform Tax Expenditures" (JCS-02-05), which was prepared in response to a request from Senators Grassley and Baucus for suggestions on how to close the "tax gap." Options for improved compliance and reform of tax expenditures that the insurance industry may want to watch include proposals for: (1) greater conformity between I.R.C. § 403(b) and I.R.C. § 401(k) plans; (2) extension of the qualified plan I.R.C. § 72(t) early-withdrawal tax to I.R.C. § 457 plans; (3) modification of the IRA prohibited transaction rules; (4) extension of the bank pro-rata disallowance of interest expense to property/casualty insurers (in lieu of the current 15% proration provision) for tax-exempt interest, the dividends received deduction and the inside build-up of cash value life insurance contracts; (5) limiting the tax-exempt status for fraternal benefit societies that provide commercial-type insurance; and (6) curtailing the use of Crummey powers (which may be used in life insurance trusts). See Legislation.

I.R.C. §§ 7702 and 7702A — Expense Charge Rule Includes Charges for QABs

The IRS has determined, in Rev. Rul. 2005-6, 2005-6 I.R.B. ___, that, for purposes of determining whether a contract satisfies the guideline premium requirements of I.R.C. § 7702(c) for qualification as a life insurance contract under I.R.C. § 7702, the company must use the same expense charge rule applicable for the cash value accumulation test and for the MEC seven-pay test. See Policyholder Issues.

I.R.C. §§ 6662A and 6707A — IRS Issues Guidance on New Reportable Transaction Disclosure, Penalty Provisions

On January 28th, the IRS released Notice 2005-17, 2005-8 I.R.B. ___, which provides that if a person became a material advisor between October 22, 2004 (the effective date of new I.R.C. § 6111 in the Jobs Act), and January 29, 2005, such material advisor has until March 1, 2005, to file a return under the new tax law. As a result, material advisors as defined in I.R.C. § 6111 and Notice 2004-80, 2004-50 I.R.B. 963, have until March 1, 2005, to file Form 8264 disclosing reportable transactions. See Company Issues.

LEGISLATION

1. In General

Congress has spent most of January reorganizing itself given the election results, appointing new members to the various legislative committees. In the tax area, discussion has been focused on Social Security and tax reform proposals that the Administration is expected to make. Although there has been a lot of discussion about what the Administration might propose for Social Security reform, there is no clear time frame for when an actual proposal might be made. The Administration did appoint a Tax Reform Commission to study the current tax code and report recommendations to the Administration by July. This tax reform schedule has been taken by some people as indicating the seriousness of the Administration's intention to reform the tax code. However, the general wisdom of Capitol Hill watchers is that tax reform will take a back seat to Social Security reform in 2005 and that tax legislation in 2005 likely will be limited to technical corrections for the more recently passed tax acts.

2. Options to Improve Tax Compliance and Reform Tax Expenditures — A List of "Revenue Raisers" Proposed by the Staff of the Joint Committee on Taxation

On January 27th, the staff of the Joint Committee on Taxation issued a report on "Options to Improve Tax Compliance and Reform Tax Expenditures" (JCS-02-05), which was prepared in response to a request from Senators Grassley and Baucus for suggestions on how to close the "tax gap." Many of the suggestions are less about how to close the difference between what the tax code provisions might be expected to collect and what they actually collect (i.e., improved compliance) and more about the elimination of tax expenditures (which might be characterized as Congressionally sanctioned tax benefits, with tax benefits being a difference between taxable income and "economic income"). In the past, elimination of tax expenditures has generally been viewed as a tax increase. The question now is whether the packaging of eliminating tax expenditure options as "reform," in conjunction with the idea of improved compliance, will change that view. It may depend on what the tax-writing committees want to do this year.

Options for improved compliance and reform of tax expenditures that the insurance industry may want to watch include proposals for: (1) greater conformity between I.R.C. § 403(b) and I.R.C. § 401(k) plans; (2) extension of the qualified plan I.R.C. § 72(t) early-withdrawal tax to I.R.C. § 457 plans; (3) modification of the IRA prohibited transaction rules; (4) extension of the bank pro-rata disallowance of interest expense to property/casualty insurers (in lieu of the current 15% proration provision) for tax-exempt interest, the dividends received deduction and the inside build-up of cash value life insurance contracts; (5) limiting the tax-exempt status for fraternal benefit societies that provide commercial-type insurance; and (6) curtailing the use of Crummey powers (which may be used in life insurance trusts).

POLICYHOLDER ISSUES

1. I.R.C. §§ 61 and 79 — Employees Taxed on Dependent Group Life Insurance

In TAM 200502040 (Jan. 14, 2005), the IRS concluded that (a) group universal life insurance coverage offered on an after-tax basis as supplemental insurance to employees covered by a group-term

life insurance plan is not taxable under I.R.C. § 79, but (b) dependent group life insurance offered on an after-tax basis to employees is taxable in accordance with Treas. Reg. § 1.61(d)(2)(ii)(B), to the extent the "cost" of the coverage determined under Table 1 of Treas. Reg. § 1.79-3(d)(2) exceeds the amount paid by the employee. In the facts of the ruling, the employees of a large corporation were offered basic group term life insurance. Employees also were eligible to purchase supplemental life insurance through a group universal life program on an after-tax basis. Although the premiums could be deducted from employees' paychecks, the corporation did not sponsor the group universal life program. Finally, the corporation arranged for employees to be offered the option of purchasing dependent group life insurance on an after-tax basis. All programs were offered by the same independent insurance company and were independently administered. The IRS determined that no amount attributable to an employee's coverage under the group universal life program was taxable under I.R.C. § 79 because the universal life insurance was offered under a separate employee-pay-all policy. However, the IRS determined that the dependent group life program must be considered group-term life insurance and that the employees were taxable under Treas. Reg. § 1.61(d)(2)(ii)(B), to the extent the cost of the dependent group insurance exceeded the amount paid on an after-tax basis, because the insurance was provided in connection with services. The IRS concluded that the income from the dependent group life coverage was wages subject to FICA and withholding, but not wages for purposes of FUTA.

2. I.R.C. §§ 61 and 1001 — Class Action Suit Damages Exceeding Policyholder's Basis in Life Insurance Policies Includible in Gross Income

The IRS determined, in CCA 200504001 (Oct. 12, 2004), that damages received from a class action lawsuit are includible in gross income only to the extent that they exceed the policyholder's basis in the life insurance policies at issue, with "basis" being defined as the premiums paid, reduced by the cost of insurance provided and amounts previously received and not included in income. In the facts presented, a woman held two life insurance policies issued by the same insurance company. One policy, which was on her former husband's life, was converted to a policy with a lower face amount when the company encouraged her to do so by erroneously guaranteeing that by using the cash surrender value from the converted policy to pay for the new policy, she would not incur any additional premiums. The other policy, on her own life, was surrendered. A class action suit was brought against the insurance company, with claims that the insurer induced policyholders to surrender, borrow against or otherwise withdraw values from their policies by misrepresenting the financial effect of such transactions and failing to disclose that such switches were against the policyholders' best interests. The policyholder in the CCA filed a return reporting the entire settlement as income and later amended her return, seeking a refund for the settlement amounts in excess of interest, arguing that such amounts represented the recovery of out-of-pocket expenses. The CCA concludes that the damage payments received by the policyholder are not includible in her gross income to the extent they exceed her "basis" in the insurance policy and explains that the "basis" is the amount of premiums paid, less the sum of the cost of insurance protection and any amounts received under the contract that were not previously included in gross income. With respect to damages attributable to the policy on her own life, the CCA determines that all amounts should be included in the policyholder's gross income because the policy was surrendered.

The analysis for this CCA appears to consider neither the origin of the claim doctrine nor the application of I.R.C. § 72 to the situation in question. Given that the "investment in the contract" (otherwise known as "basis") under I.R.C. § 72(c)(1) is not adjusted for the cost of insurance protection, one has to wonder if there are pertinent facts missing from the CCA's explanation.

3. I.R.C. § 1234A — Payments Received by Company from COLI Termination Are Ordinary Income

The IRS concluded, in TAM 200452033 (Sept. 27, 2004), that income a corporation receives from the termination of its corporate-owned life insurance ("COLI") contracts would not be considered property subject to I.R.C. § 1234A when amounts are ordinary income accretion to the contract's value. In the facts of the TAM, a parent corporation entered a closing agreement with the IRS to resolve the treatment of interest deductions related to its COLI program. Under the terms of the closing agreement, the corporation agreed to terminate many of its COLI whole life insurance contracts with payment from the termination allocated between cash payments and satisfaction of the corporation's loan obligations, and the IRS agreed that the corporation would recognize only a percentage of the termination payment in its gross income. The IRS concluded that, although the definition of property under I.R.C. § 1221 does not include whole life insurance as an exclusion from capital assets, the Supreme Court, in United States v. Midland Rose Corp., 381 U.S. 54 (1965) and Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988), determined that accretions to value of a capital asset that are properly attributable to ordinary income are excluded from capital asset treatment. As a result, the amounts the corporation receives would not be considered capital assets under I.R.C. § 1234A so long as the amounts constitute ordinary income accretions to the contract's value.

4. I.R.C. §§ 7702 and 7702A — Expense Charge Rule Includes Charges for QABs

The IRS has determined, in Rev. Rul. 2005-6, 2005-6 I.R.B. ___, that charges for qualified additional benefits ("QABs") should be taken into account under the expense charge rule of I.R.C. § 7702(c)(3)(B)(ii). In the facts of the ruling, a life insurance company issues a policy with a term rider that provides term life insurance coverage on the life of a family member of the insured. The insurer imposes a charge for the mortality risk it assumes under the rider and subtracts this charge from the cash value. The IRS concluded that, for purposes of determining whether a contract satisfies the guideline premium requirements of I.R.C. § 7702(c) for qualification as a life insurance contract under I.R.C. § 7702, the company must use the same expense charge rule applicable for the cash value accumulation test and for the MEC seven-pay test. The IRS found that there is no indication that Congress intended, in any case, to take into account charges for QABs, such as the term rider, that exceed amounts reasonably expected to actually be paid.

5. Contingent Fees Paid Directly to Attorneys Are Taxable Income to Clients

The Supreme Court, in Commissioner v. Banks, Nos. 03-892 and 03-907 (U.S. Jan. 24, 2005), ruled that contingent attorneys' fees, even when paid directly to attorneys, are considered taxable income to their clients. In the consolidated cases, following the settlement of employment discrimination claims, the claimant taxpayers did not include as gross income the amount of the settlement payment that was paid to their attorneys under contingent-fee agreements. The IRS issued notices of deficiency, maintaining that such fees were includible in gross income, which was confirmed in the Tax Court. When the cases reached the Courts of Appeal for the Sixth and Ninth Circuits, the decisions were reversed and the attorneys' fees were ruled not to be includible in gross income. To determine whether the amount spent on fees was includible, the Supreme Court examined whether the income was attributable to the attorney or the client. The Court noted that attribution of income is generally resolved by determining whether a taxpayer exercises complete dominion over the income in question, or the

income-generating asset. Stating that the income-generating asset is the client's legal injury, the Court concluded that the client retained dominion over the assets at all points during litigation. The Court stated that the anticipatory assignment of income doctrine, providing generally that assigning the economic gain from gross income to another party in advance does not permit a taxpayer to exclude such gain, is not limited to instances in which the precise value of income is known in advance. Thus, although the value of the claimants' claims were unclear at the time the contingent-fee arrangements were made, the amount of the fees remain includible in the gross income for the claimants as taxpayers. Accordingly, the Court reversed the circuit courts' opinions and remanded the cases.

COMPANY ISSUES

1. I.R.C. § 409A — Non-Qualified Deferred Compensation Transition Rules Clarified

On January 4th, corrections to the transition relief in the question-and-answer section of advance Notice 2005-1, 2005-2 I.R.B. 258, regarding the treatment of non-qualified deferred compensation plans under I.R.C. § 409A, were issued. More specifically, a clarification of Q&A 19 sets for certain amendments and elections that will not be treated as a change in the form or timing of a payment under I.R.C. § 409A, nor as an acceleration of benefits under I.R.C. § 409A(a)(3). The transition relief in Q&A 20, which provides that certain terminations of participation in a plan and certain cancellations of deferral elections by participants will not fail to conform to I.R.C. § 409A(a)(2) through (4), is also clarified to be applicable to deferrals made prior to 2005 that are subject to I.R.C. § 409A.

2. I.R.C. § 807 — Change in Treatment of Deferred and Uncollected Premiums in Calculation of Reserves Was Unauthorized Change in Accounting Method

In CCA 200504030 (Oct. 15, 2004), the IRS concluded that a life insurance company's removal of obligations associated with deferred and uncollected premiums in calculating its tax reserves was an unauthorized change in accounting method. In the facts presented, a life insurance company recognized deferred and uncollected premiums as reported on its Annual Statement and included in its tax reserves, for federal income tax purposes, the obligations associated with these amounts. The following year, the company removed such obligations from its reserve calculations on the basis that such a change was permissible under I.R.C. § 807(f) and Rev. Rul. 94-74, 1994-2 C.B. 157. The company later filed a request for a change in accounting method to allow it to no longer report the deferred and uncollected premiums in its underwriting income. The IRS notified the IRS Field Office that the company's change in the reserve computations, excluding obligations associated with deferred and uncollected premiums, constituted an unauthorized change in accounting method, and that the accounting change that was requested was integrally related to unauthorized change regarding the reserve computations.

3. I.R.C. § 817 — Guidance on Application of Look-Through Rule to RICs Issued

In Rev. Rul. 2005-7, 2005-6 I.R.B. ___, the IRS determined that the look-through rule of I.R.C. § 817(h)(4) applies to the investments of variable contracts into a regulated investment company ("RIC"), which are subsequently invested in a second RIC, because the contracts' interests in the RICs are held by a segregated separate account and public access to the RIC is available only through variable annuity purchases. The facts presented in the ruling involve a life insurance company that offers variable life and

variable annuity contracts, which qualify as variable contracts under I.R.C. § 817(d). The contracts are funded by segregated assets that are held in sub-accounts, one of which is a segregated asset account invested exclusively in a RIC. More than 55% of the value of its total assets of this RIC are then invested in a second RIC. Both RICs are accessible only through the purchase of a variable contract, and all the beneficial interests are held in segregated accounts of insurers. The first RIC is adequately diversified if the look-through rule of I.R.C. § 817(h)(4) and Treas. Reg. § 1.817-5(f)(1) is applied and the first RIC is treated as owning a pro rata portion of each asset in the second RIC. The second RIC is adequately diversified under I.R.C. § 817(h)(1) and Treas. Reg. § 1.817-5(b). The IRS determined that the RICs satisfy the requirements of the look-through rule, being held by separate accounts and available to the public only through the purchase of variable contracts. Consequently, for purposes of satisfying the diversification requirements of I.R.C. § 817(h), the segregated asset account is treated as owning a pro rata portion of the first RIC's assets, including a pro rata portion of the second RIC's assets.

4. I.R.C. §§ 832 and 953 — IRS Rules Vehicle Service Arrangements Not Shams for Federal Income Tax Purposes

In TAMs 200453012 (undated) and 200453013 (Oct. 6, 2004), the IRS concluded that arrangements involving the sale and administration of vehicle service agreements were not shams for federal income tax purposes. In the facts of both rulings, an S corporation motor vehicle dealership offered vehicle service agreements, provided by a sponsor insurance company, to its customers. The sponsor insurance company required the dealership to join an insurance purchasing group. This group became a member of a trust intended to provide group insurance, which arranged for reinsurance by a tax-exempt foreign reinsurer owned by the S corporation. In examining the facts, the IRS concluded that the insurance transactions were not shams-in-fact because failure to fix defects under the vehicle service agreements would have resulted in a breach under state law. As a result, the IRS could not argue that insurance transactions that were part of the arrangement would not take place. In addition, the IRS concluded that the transactions would not be considered shams-in-substance because the company had a valid business purpose in entering the transactions. Specifically, the transactions provided for the insurance risks covered under the vehicle service agreements by establishing a separate source of funding to ensure those obligations could be met. Finally, the IRS determined that the foreign reinsurer would be considered an insurance company if it was a domestic corporation and was eligible to be treated as a domestic corporation under I.R.C. § 953(d).

5. I.R.C. § 833 — Taxation of Company Not Affected by Change in BCBS Operations

In TAM 200453014 (Aug. 13, 2004), the IRS determined that a not-for-profit health and accident insurer, during tax years after it lost its Blue Cross Blue Shield ("BCBS") license, did not undergo a material change and continues to qualify as an existing BCBS organization under I.R.C. § 833. In the facts of the TAM, a BCBS organization was in existence before August 16, 1986, and was exempt from tax during its last tax year predating January 1, 1987. After a merger attempt with a major hospital group failed, the organization's rights to the BCBS trademark and trade name were revoked. Due to this loss of the BCBS license, the company changed its name and subsequently merged with other national healthcare provider networks and continued to operate as a not-for-profit mutual company, providing health and accident insurance. The TAM considered whether, without regard to any changes in operation or structure, the company qualified as an BCBS organization under I.R.C. § 833 in years after it lost its BCBS license. Examining the legislative history of I.R.C. § 833, the IRS concluded that neither the

statute nor the legislative history requires an entity to continue to be licensed by the BCBS association to be considered an existing BCBS organization for taxable years after the license was lost. Further, the IRS found that the loss of the license did not constitute a material change in operations or structure of the organization under I.R.C. § 833(c)(2)(C), stating that the corporate structure was not affected and the change in provider networks were not the type of change in operation that were described as material changes in the legislative history.

6. I.R.C. § 965 — Repatriated Foreign Dividends, Used for Certain Purposes, Allowed Time-Limited Tax Break

In what is expected to be the first of many releases on the issue, Notice 2005-10, 2005-6 I.R.B. ___, provides broad guidance under I.R.C. § 965 on tax breaks for foreign dividends returned to and reinvested in the United States for a variety of specified uses. The American Jobs Creation Act of 2004, Pub. L. No. 108-357, added I.R.C. § 965, which allows U.S. shareholders of a controlled foreign corporation ("CFC") to elect to take a one-year dividends received deduction equal to 85% of the cash dividends received from the CFC during that taxable year. Detailed in Notice 2005-10 are several parameters for domestic reinvestment plans, as well as the types of investments for which repatriated funds may be used under I.R.C. § 965, such as infrastructure and capital investments, research and development, acquisitions of interest in business entities, and intangible property. Also listed in the Notice are investments that are not considered appropriate investments under I.R.C. § 965(b)(4), including inter-company distributions, obligations and transactions, dividends and other distributions with respect to stock, portfolio investments in business entities, debt instruments, and tax payments. A safe harbor to encourage taxpayers to invest repatriated funds is also provided.

7. I.R.C. §§ 6662A and 6707A — IRS Issues Guidance on New Reportable Transaction Disclosure, Penalty Provisions

Since the first of the year, the IRS has released several Notices providing interim guidance on disclosure requirements for reportable transactions, recently enacted by the American Jobs Creation Act of 2004 (Pub. L. No. 108-357), including guidance on the related penalties for failure to disclose and extending the due date for material advisors to disclose involvement in reportable transactions.

Notice 2005-11, 2005-7 I.R.B. ___, which describes new I.R.C. § 6707A, specifically provides that the IRS will impose a penalty with respect to each reportable transaction that a taxpayer fails to disclose. A single penalty will be imposed on taxpayers that fail to: (1) attach Form 8886 to their tax return; and (2) send a copy of the same form to the Office of Tax Shelter Analysis as required by Treas. Reg. § 1.0611-4(e). The IRS also stated that the IRS will take into account all relevant facts and circumstances in determining whether to rescind the penalty for non-listed reportable transactions when the rescission would promote compliance with the requirements and effective tax administration.

Notice 2005-12, 2005-7 I.R.B. ___ describes I.R.C. § 6662A, which imposes an accuracy-related penalty for understatements with respect to listed transactions and reportable transactions with a significant tax avoidance purpose. The penalty rate and defenses available vary and depend upon whether the transaction was adequately disclosed. The interim guidance states that a transaction has been adequately disclosed if the taxpayer has filed a Form 8886 or has disclosed the transaction in its Schedule M-3. Notice 2005-12 also provides guidance regarding the amendments to I.R.C. § 6664, which provide

that a taxpayer may not rely on an opinion of a tax advisor if the opinion either is provided by a disqualified tax advisor or is a disqualified opinion.

Finally, on January 28th, the IRS released Notice 2005-17, 2005-8 I.R.B. ___, which provides that, if a person became a material advisor between October 22, 2004 (the effective date of new I.R.C. § 6111 in the Jobs Act), and January 29, 2005, such material advisor has until March 1, 2005, to file a return under the new tax law. As a result, material advisors as defined in I.R.C. § 6111 and Notice 2004-80, 2004-50 I.R.B. 963, have until March 1, 2005, to file Form 8264 disclosing reportable transactions.

The IRS has requested public comments on each Notice and the issues to which they pertain. Comments are encouraged to be submitted by February 28, 2005.

8. IRS Loosens Pre-Filing Agreement Program Guidelines

In Rev. Proc. 2005-12, 2005-2 I.R.B. 311, the IRS revised the guidelines for its prefiling agreement program, allowing for multi-year agreements that extend to future tax years and providing new rules on the eligibility of domestic and international issues. Under the revised guidelines, taxpayers can enter into prefiling agreements that resolve issues for the current year and up to four future taxable years. Additionally, Rev. Proc. 2005-12 drops the earlier lists of domestic and international prefiling agreement issues. Instead, the revenue procedure states that, other than those on the list of excluded issues (which includes issues involving transfer pricing, most changes in accounting method, annual accounting periods, and tax shelters), any domestic or international issue that requires a determination of facts or application of well-known legal principles to known facts is likely to be suitable for a prefiling agreement. The revenue procedure is effective from December 22, 2004 until December 31, 2006, unless sooner revoked, modified, or superceded.

9. Temporary and Proposed Regulations Require E-Filing by Some Large Corporations, Private Foundations

Under temporary and proposed regulations released on January 11th (T.D. 9175; REG-130671-04), certain large corporations and private foundations will be required to electronically file tax returns beginning in tax year 2005. For tax year 2005, corporations with total assets exceeding $50 million filing Forms 1120 and 1120S and tax-exempt organizations with assets exceeding $100 million filing Forms 990 will be required to e-file. The threshold for assets is lowered to $10 million for both corporations and tax-exempt organizations for tax year 2006. Private foundations and charitable trusts are also required to e-file Forms 990-PF beginning in 2007. These requirements apply only to businesses and organizations that file at least 250 returns during a calendar year, including income tax, excise tax, employment tax and information returns. The temporary and proposed regulations additionally include provisions regarding the filing of amended and corrected returns and providing a hardship waiver and exclusions. The temporary regulations take effect on February 12, 2005. Comments on the proposed regulations, as well as requests to speak at the March 16, 2005, public hearing on the proposed regulations, are due by February 28, 2005.

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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