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TAX ISSUES SUMMARY

March 31, 2005

HIGHLIGHTS:

I.R.C. §§ 263 and 1092 — IRS Concludes Taxpayer Liability Can Be a Position in a Straddle

In TAM 200509022 (Oct. 6, 2004), the IRS adopted the position that unsecured subordinate debt instruments issued by a parent corporation can constitute positions in a straddle with certain portfolio stock held by the taxpayer. The TAM concluded that the instruments and stock were offsetting positions because the principal the parent owed on the debt was related to the value of the stock. See Company Issues.

I.R.C. § 6603 — IRS Provides Procedures for Deposits to Suspend Interest on Underpayments

Rev. Proc. 2005-18, 2005-13 I.R.B. 798, establishes procedures for taxpayers to make, identify and withdraw deposits to suspend the running of interest on deficiencies, including those treated as deposits under I.R.C. § 6603. I.R.C. § 6603 allows taxpayers to make cash deposits 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 deposits will be returned with interest at the federal short-term rate. Rev. Proc. 2005-18 is effective March 28, 2005, and applies to deposits made after October 22, 2004. See Company Issues.

LEGISLATION

In General

Congress is still in the process of laying the “groundwork” for what tax legislation might be taken up in 2005. Both the House and the Senate budget bills have tax provisions, but those bills have yet to be

made into a single budget resolution. Assuming Congress succeeds in adopting a budget resolution (which some say may not occur until late summer), the tax focus generally is predicted to be on extension of earlier tax reductions. Meanwhile, tax staffs on Capitol Hill continue to gather technical corrections for the Jobs Act, as well as some earlier tax acts, so technical corrections will be ready whenever tax legislation moves in 2005.

Although the potential restructuring and reform of Social Security are not tax specific, both tax-writing committees of Congress continue to consider, and sometimes participate in, the ongoing discussions. Predictions continue to be that potential restructuring of Social Security will be the primary focus of those committees this year.

POLICYHOLDER ISSUES

1. I.R.C. §§ 162 and 264 — Contributions to VEBA Used to Buy Life Insurance Are Deductible

In TAM 200511015 (Dec. 8, 2004), the IRS concluded that an employer could deduct, under I.R.C. § 162(a), contributions to a voluntary employees' benefit association ("VEBA") used to buy life insurance that, in turn, was used to fund post-retirement welfare benefits of the employer. In the facts of the TAM, a corporation made contributions to a VEBA, which used the funds to purchase, through a trust, life insurance policies to fund post-retirement welfare benefit payments provided by the corporation to its employees. The examining agent argued that the corporation's contributions to the VEBA were actually the annual premium payments for the policies and that I.R.C. § 264(a)(1), providing that life insurance premiums are not deductible if the payor is directly or indirectly a beneficiary, prevents the corporation from deducting such amounts. The TAM rejected this argument, stating that, because the assets of the employee benefit plan funded by the VEBA could not be used for the benefit of the corporation unless the corporation violates its fiduciary duty to its employees under ERISA, no agency, conduit or other arrangement could be deemed to exist between the corporation and the VEBA. Thus, without evidence that the corporation would violate its fiduciary duty, the corporation could not be viewed as the payor of the premiums, and I.R.C. § 264(a)(1) was inapplicable. The TAM concluded that the corporation did not make premium payments under I.R.C. § 264 and could deduct amounts contributed to the VEBA as ordinary and necessary expenses under I.R.C. § 162(a). The TAM assumed as fact that the amount of the contributions did not violate the account limits for the employee benefit plan funded by the VEBA.

2. I.R.C. § 817 — Final Regulations Eliminate Look-Through Rule for Non-Registered Partnerships

In T.D. 9185, 2005-12 I.R.B. 749, the IRS eliminated, for purposes of satisfying the diversification test of I.R.C. § 817(h), a "look-through" rule for the assets of a non-registered partnership. Adopting provisions from the proposed regulations (REG-163974-02), the final regulations delete a provision of the

prior regulations that applied a “look-through” rule to assets of a non-registered partnership for purposes of satisfying the diversification requirements of I.R.C. § 817(h). Additionally, in response to comments received regarding the definition of “security” in Treas. Reg. § 1.817-5(h)(6), under which all securities of the same issuer are treated as one investment for purposes of satisfying the diversification requirements, the prior distinction between registered and non-registered partnership interest is removed by these regulations. The regulations are effective as of March 1, 2005.

The final regulations also extend the time for existing arrangements to be brought into compliance with the new provisions. An existing segregated asset account will be considered adequately diversified if, as of March 1, 2005, it was adequately diversified under I.R.C. § 817(h) and the regulation in effect prior to March 1, 2005, and is adequately diversified within the meaning of I.R.C. § 817(h) and the current regulation by December 31, 2005.

3. I.R.C. § 817 — Look-Through Rule Applies to Direct and Indirect Investments in Tiered Investment Portfolios

In PLR 200508002 (Sept. 30, 2004), the IRS determined that the look-through rule applies to a subaccount that invests, either directly or indirectly, in shares of a lower-tier fund such that a pro rata share of the assets of the lower-tier fund is treated as assets of the subaccount for purposes of the diversification test of I.R.C. § 817(h). In the facts of the ruling, a number of life insurance companies, owned by a common, non-insurance company parent, each issue variable life insurance contracts and/or variable annuity contracts based on one or more separate accounts. The assets of the separate accounts are attributable to various subaccounts, and the investment return and market value of the assets held by each are allocated in an identical manner to any variable contract supported by that subaccount. The subaccounts invest, or will invest, in shares of particular I.R.C. § 851(a) regulated investment companies (“RICs”). Some of the RICs are comprised entirely of individual securities (“lower-tier funds”), while others primarily hold, or will hold, shares of the lower-tier funds (“upper-tier funds”). Except as otherwise permitted by Treas. Reg. § 1.817-5(f)(3), lower-tier funds are available for purchase only by segregated asset accounts and subaccounts in support of variable contracts, upper-tier funds and third party funds (which are available exclusively through the purchase of a variable contract), while upper-tier funds are available for purchase exclusively by segregated asset accounts and subaccounts in support of variable contracts. The IRS examined arrangements in which multiple upper-tier funds invest in a single lower-tier fund (master-feeder arrangements) and those in which a single upper-tier fund invests in multiple lower-tier funds (fund of funds arrangements). To the extent a taxpayer holds, or will hold, an interest in any of the RICs, the return on such interest will be computed in the same manner that the return on an interest held by a segregated asset account is computed.

Based on the facts, the IRS determined that, because the lower-tier funds are available exclusively through the purchase of variable contracts, except as otherwise permitted by Treas. Reg. § 1.817-5(f)(3), the requirements of Treas. Reg. § 1.817-5(f)(2) are satisfied with respect to subaccounts that invest in the lower-tier funds. Similarly, indirect investments by subaccounts in lower-tier funds through investments in upper-tier funds satisfy the requirements of Treas. Reg. § 1.817-

5(f)(2). Thus, the look-through rule applies such that a pro rata share of the assets of each lower-tier fund will be treated as assets of the subaccount for purposes of the I.R.C. § 817(h) diversification test.

COMPANY ISSUES

1. **I.R.C. §§ 263 and 446 — IRS Modifies Guidance on Accounting Method Change for the Capitalization of Intangibles**

Modifying earlier guidance on obtaining automatic consent for an accounting method change for the capitalization of intangibles, Rev. Proc. 2005-17, 2005-13 I.R.B. 797, provides a waiver of the 5-year prior change scope limitation. Earlier this year, Rev. Proc. 2005-9, 2005-2 I.R.B. 303, provided instructions for a taxpayer's filing of Form 3115, Application for Change in Accounting Method, to obtain automatic consent for a change in accounting method for capitalizing intangibles during its second taxable year ending on or after December 31, 2003. Some taxpayers were ineligible to obtain automatic consent to change accounting methods under Rev. Proc. 2005-9 because they failed to meet the requirement of section 4.02(6) of Rev. Proc. 2002-9, 2002-1C.B. 327, which prevents taxpayers from obtaining automatic consent if, within the last five taxable years, they have either changed the same method of accounting or applied to change the same method of accounting without effecting the change. Consequently, Rev. Proc. 2005-17 modifies Rev. Proc. 2005-9, waiving the 5-year prior change scope limitation of section 4.02(6) of Rev. Proc. 2002-9.

2. **I.R.C. §§ 263 and 1092 — IRS Concludes Taxpayer Liability Can Be a Position in a Straddle**

In TAM 200509022 (Oct. 6, 2004), the IRS concluded that two contingent debt instruments issued by a parent corporation were part of a straddle under I.R.C. § 1092(d) and the parent's payments on the two instruments constituted interest and carrying charges under I.R.C. § 263(g)(2)(A). In the facts of the ruling, a parent corporation issued two identical unsecured debt instruments that were referenced to different portfolio stock in two subsidiaries. The parent claimed a current deduction for expenses regarding the early redemption of one of the instruments and claimed a deduction for the amortization of underwriting costs for the other. The TAM determined that the instruments issued by the parent constituted positions in a straddle with certain portfolio stock. The TAM also concluded that the instruments and stock were offsetting positions because the principal the parent owed on the instruments was related to the value of the stock. Finally, the TAM concluded that payments on the two instruments constituted interest and carrying charges, which were incurred or continued to purchase or carry the offsetting positions for purposes of I.R.C. § 263(g)(2)(A).

The TAM's conclusion is surprising for several reasons. First, a straddle consists of offsetting positions with respect to personal property, and a debt is a liability and generally not considered property. Despite acknowledging this fact in the TAM, the IRS, with little rationale, ignores it. Second, even if a straddle exists, it is not clear what unrealized gain can exist in the liability that can serve to defer any

losses realized on the stock. Third, it is questionable that the debt instrument is a position “substantially similar or related to” the stock under former I.R.C. § 1092(d)(3)(B)(i)(II).

3. I.R.C. § 847 — IRS Restores SETPs after Deficiency Caused by IRS Error, Marginal Rate Change

The IRS determines, in CCA 200512017 (Feb. 18, 2005), that an insurer is entitled to the restoration of special estimated tax payments (“SETPs”) to its special loss discount account (“SLDA”) for deficiencies that were created due to IRS oversight, audit adjustments and the interplay of the 1993 marginal rate change and I.R.C. § 847(7). In the facts presented, an insurance company claimed deductions under I.R.C. § 847(1) by making SETPs, as described in I.R.C. § 847(2), and established and maintained an I.R.C. § 847(3) SLDA. Pursuant to I.R.C. § 847(5), the insurer reported income in the following years and the resulting tax liability was offset using the previously paid SETP amounts, reversing the full amount of the SLDA that had been previously deducted. In the final years the SETPs were made, there were insufficient funds in the SLDA to cover the liabilities, and the IRS applied funds from the company’s regular estimated tax payments to cover the deficiencies. The company argued that the IRS erred in its maintenance of the company’s SLDA, causing the company to be double-taxed due to audit adjustments and the I.R.C. § 11 corporate tax rate change that occurred in 1993. The company requested a correction to the I.R.C. § 847 accounts, reflective of the adjustments mandated by I.R.C. § 847, restoring the SETPs and providing for a refund of the estimated tax payments used to cover the deficiencies. In the CCA, the IRS concludes that the company is entitled to a SETP restoration as a result of the interplay of the change in the corporate tax rate and I.R.C. § 847 and also is entitled to a SETP restoration for audit adjustments. Under I.R.C. § 6655, these restored amounts will be treated as estimated tax payments and subject to a claim for credit or refund.

4. I.R.C. § 6603 — IRS Provides Procedures for Deposits to Suspend Interest on Underpayments

In Rev. Proc. 2005-18, 2005-13 I.R.B. 798, the IRS established procedures for taxpayers to make, identify and withdraw deposits to suspend the running of interest on deficiencies, including those treated as deposits under I.R.C. § 6603. The American Jobs Creation Act of 2004, Pub. L. No. 108-357, created I.R.C. § 6603, allowing taxpayers to make cash deposits with respect to disputable tax liabilities in order to suspend the running of interest on potential underpayments and providing that, upon written request by the taxpayer, such deposits will be returned with interest at the federal short-term rate. Rev. Proc. 2005-18 provides that deposits may be made under I.R.C. § 6603 by remitting a check or money order, accompanied by a written statement designating the remittance as a deposit. Payments without such designations will be applied to outstanding taxes, penalties and interest owed, beginning with the earliest tax period, and deposits exceeding outstanding liabilities will be applied against other assessed and unassessed liabilities. Upon written request from the taxpayer, the IRS will return any portion of a deposit not used to pay tax. For purposes of computing interest on underpayments, owed taxes will be treated as paid on the date a deposit is made, and interest on deposits will be paid to taxpayers to the extent the deposit is attributable to a disputable tax. Rev. Proc. 2005-18 is effective March 28, 2005, and applies to

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deposits made after October 22, 2004. Deposits made between October 22, 2004, and March 28, 2005, will be treated as made on the date remitted if a written statement designating the amount as a deposit under I.R.C. § 6603 is submitted by May 27, 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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