

# SCRIBNER, HALL & THOMPSON, LLP

SUITE 1050

1875 EYE STREET, N. W.

WASHINGTON, D. C. 20006-5409

(202) 331-8585

FAX (202) 331-2032

Writer's Direct Dial: (202) 434-9172

Writer's Email Address:

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

THOMAS C. THOMPSON, JR.  
MARK H. KOVEY  
STEPHEN P. DICKE  
PETER H. WINSLOW  
SUSAN J. HOTINE  
BIRUTA P. KELLY  
GREGORY K. OYLER  
LORI J. BROWN  
SAMUEL A. MITCHELL  
JOSEPH A. SERGI

FRED C. SCRIBNER, JR. (1908-1994)  
LEONARD W. HALL (1900-1979)

## TAX ISSUES SUMMARY

**June 30, 2005**

### ***HIGHLIGHTS:***

#### **I.R.C. §§ 162 and 831 — Guidance Released on Qualification Requirements for Arrangements to Be Considered Insurance for Federal Income Tax Purposes**

Rev. Rul. 2005-40, 2005-27 I.R.B. \_\_\_\_, details four situations that illustrate the IRS's position on when adequate risk distribution is or is not present in order for an arrangement to be treated as insurance when there is only one "insured," notwithstanding the arrangement covered a significant volume of independent, homogeneous risks. In Notice 2005-49, 2005-27 I.R.B. \_\_\_\_, the IRS requests comments on what additional guidance should be issued regarding what is insurance, including the issue covered in Rev. Rul. 2005-40. See Policyholder Issues.

#### **Draft 2005 Schedule M-3 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. The IRS has made several changes to and replaces the prior Schedule M-3. Also of note, the IRS is developing Schedules M-3 for Forms 1120PC and 1120L for use by insurance companies to be effective December 31, 2005. See Company Issues.

## LEGISLATION

### **1. In General**

As Congress adjourns for the July 4<sup>th</sup> holiday, some tax legislation is being queued up for passage this summer. On June 28<sup>th</sup>, the Senate passed the Energy Bill, which is expected to go into conference when Congress returns; combining the Senate and House tax titles is expected to be the least of the conferees' worries. Although Sens. Baucus's (D-Mont.) and Kyl's (R-Ariz.) efforts are directed toward arriving at a compromise regarding the repeal of the estate tax, most Hill watchers expect that a compromise with a combination of higher exemption amounts and lower rates will be adopted some time

this year in lieu of a permanent repeal of the estate tax. Finally, July also could yield some tax legislation addressing charitable governance, as well as dealing with pension funding and reform issues.

## **2. Legislators Introduce Bills on Annuities and Long-Term Care**

On June 14<sup>th</sup>, House Ways and Means Committee Chairman Thomas (R-Cal.) suggested legislative alternatives that would make annuity products more attractive and flexible. For example, Rep. Thomas proposed the creation of an inheritance annuity package, which would permit the estate of an annuitant that dies shortly after purchasing the annuity to transfer a portion of the cash value to the annuitant's beneficiaries. Rep. Thomas has the support of the American Council of Life Insurers ("ACLI"), who has shared information, ideas and data with the Ways and Means Committee on this issue. The ACLI also has provided to the Ways and Means Committee draft proposals that would provide incentives for long-term care insurance, offered in combination with other insurance products and benefits. The proposals include permitting long-term care insurance riders to be issued on life insurance and annuity contracts, and allowing tax-free exchanges of life insurance and annuity contracts for long-term care insurance contracts.

On the same day, Senate Finance Committee Chairman Grassley (R-Iowa) and Sen. Lincoln (D-Ark.) introduced the Long-Term Care and Retirement Security Act of 2005. The bill, already introduced in the House of Representatives by Reps. Johnson (R-Conn.) and Pomeroy (D-N.D.), would provide tax incentives to allow individuals a deduction for qualified long-term care insurance premiums, allow for the use of such insurance under cafeteria plans and flexible spending arrangements, and provide a credit for individuals with long-term care needs. Specifically, the bill would allow individuals above-the-line deductions for the cost of their long-term care insurance policies and a \$3,000 tax credit to help cover long-term care expenses. The bill would also allow employers to include the deduction provision for long-term care in cafeteria plans and flexible spending accounts.

Finally, on June 16<sup>th</sup>, House Ways and Means Committee Member Pomeroy sponsored the Lifetime Pension Annuity for You Act of 2005 Act, H.R. 2951, which would encourage guaranteed lifetime income payments by excluding from income a portion of such payments. Specifically, the bill would provide tax incentives to workers that annuitize part of their defined contribution retirement savings and IRAs by excluding up to \$5,000 per year of lifetime annuity payments from taxation.

## **3. Bill Introduced for Creation of Tax-Free Reserves for Nature Disaster**

On May 26<sup>th</sup>, House Ways and Means Committee Member Foley (R-Fla.) introduced H.R. 2668, a bill to allow insurers to create tax-deferred reserve accounts to deal with the costs of future natural disasters. The bill, created as a result of the impact of the 2004 hurricane season on Florida, would permit insurers to set up reserves to pay claimants who suffer losses as a result of natural disasters, including windstorms, earthquakes, snow storms, ice, freezing, fire, tsunami, floods, volcanic eruptions, and hail. This is the fourth time Rep. Foley has introduced this legislation.

## **POLICYHOLDER ISSUES**

### **1. I.R.C. § 162 — IRS Releases CCA on Health Insurance Deduction for Self-Employed Individuals**

In CCA 200524001 (May 17, 2005), the IRS examined the treatment of health insurance costs incurred by a self-employed individual. In the CCA, the IRS considered whether the insurance costs for the medical care of a sole proprietor and his spouse and dependents, provided under a health insurance policy purchased by the sole proprietor in his individual name, were deductible under I.R.C. § 162(l). The IRS concluded that the medical insurance costs may be deducted from the sole proprietor's earned income derived from his business. The IRS also considered whether the deduction may be based on the aggregate profits and losses of two or more businesses owned by the sole proprietor, establishing a net income ceiling for insurance costs deductions. Taking into account I.R.C. § 162(l)(2)(A), which provides that the earned income limit is derived from the trade or business with respect to which the plan providing the coverage was established, the IRS concluded that the deductions must be claimed for a specific coverage plan that was established under a specific trade or business, and the deductions are limited to the earned income of that specific trade or business. Additionally, if a self-employed individual established different medical plans under separate businesses (e.g., a medical plan and a dental plan), the insurance costs under each specific plan established under each specific business may be deducted up to the net earnings of the specific business.

### **2. I.R.C. §§ 162 and 831 — Guidance Released on Qualification Requirements for Arrangements to Be Considered Insurance for Federal Income Tax Purposes**

In Rev. Rul. 2005-40, 2005-27 I.R.B. \_\_\_\_, the IRS clarifies that the requirements of risk shifting and risk distribution must be met for any arrangement to be considered insurance for federal income tax purposes. In the ruling, the IRS presents four fact situations that illustrate the IRS's position of when adequate risk distribution is or is not present in order for an arrangement to be treated as insurance. In short, the ruling concludes that an arrangement that primarily insures the risk of only one business policyholder does not qualify as insurance because it does not meet the risk distribution requirement. However, if a business operates through multiple limited liability companies ("LLCs") and the LLCs are the policyholders, there is risk distribution only if the LLCs elect to be classified for tax purposes as associations. Otherwise, the LLCs are disregarded entities for tax purposes, including for purposes of determining whether there is a distribution of risk. It is interesting to note that the arrangements were found not to be insurance for tax purposes despite the fact that in each situation considered: (1) there was actual risk transfer between the policyholder and the insurance company; (2) the arrangements were arm's length transactions; and (3) the policies were operated in accordance with state insurance law.

On the same day, the IRS, in Notice 2005-49, 2005-27 I.R.B. \_\_\_\_, requested that comments on possible additional guidance concerning the standards for determining whether an arrangement constitutes insurance be submitted by October 3, 2005. Specifically, the IRS requested comments on: (1) what factors should be considered in determining whether a cell captive arrangement constitutes insurance; (2) how certain arrangements between related parties may be affected by a loan back of the amounts paid in premiums; (3) whether homogeneity of the risks covered is relevant in determining whether there is risk distribution; and (4) the federal income tax issues raised by transactions involving finite risk.

## COMPANY ISSUES

### 1. I.R.C. § 165 — IRS Will Continue to Challenge BCBS Abandonment Loss Deductions

On May 27<sup>th</sup>, the IRS released a coordinated issue paper for the health and life insurance industry in which it announced its intention to continue challenging loss deductions claimed under I.R.C. § 165 by Blue Cross Blue Shield (“BCBS”) organizations for the termination of customer and provider contracts and employee workforces. The Tax Reform Act of 1986 revoked the tax-exempt status of BCBS organizations. Section 1012(c)(3)(A)(ii) of the Act provided that an organization’s adjusted basis in each of its assets is deemed equal to the asset’s fair market value as of the first day of the first taxable year beginning after December 31, 1986. Under Notice 2000-34, 2000-2 C.B. 172, the IRS stated that some BCBS organizations were taking loss deductions when customer relationships were terminated based on the theory that each customer relationship is a separate asset and asserted that it would challenge the deductions on the basis that each relationship does not create a separate asset and, therefore, the basis cannot be deducted when one relationship terminates.

The coordinated issue paper reaffirms the Notice and applies the valuation standards adopted in Capital Blue Cross v. Commissioner, 122 T.C. 224 (Mar. 12, 2004), to similar situations. (The Capital case is currently on appeal in the Third Circuit (No. 04-2645); briefing and oral arguments have been completed and a decision is expected in the next few months.) Additionally, the coordinated issue paper provides that, for cases that were suspended without examination of the loss deduction or any formal or informal claims, the deductions or claims should now be disallowed under the legal theories of Notice 2000-34, and the taxpayer’s valuation should be carefully scrutinized and any deductions or claims that do not satisfy the Capital standard should be disallowed. For cases that were suspended after examination, the deductions or claims should now be disallowed, except that if the previous examination proposed to allow any portion of a loss based on a valuation prepared prior to March 12, 2004, the previous valuation must be re-examined to determine whether it satisfies the Capital standard. The coordinated issue paper also states that the IRS will not enter into any Agreement to Extend the Time to Bring Suit (Form 907) nor extend any previous Form 907 on the issue. Finally, the IRS stated that any BCBS organization that converts from non-profit status to for-profit status will not be considered an existing BCBS organization and thus cannot claim the fair market value basis for any transaction after the conversion.

### 2. FASB to Draft Rules on Financial Guarantee Insurance Practices

On June 8<sup>th</sup>, the Financial Accounting Standards Board (“FASB”) voted to take on a limited-scope project to write rules for insurers’ accounting for financial guarantee insurance. The project is intended to remedy differences in companies’ practices of recording claim liabilities for financial guarantee contracts. FASB states that the accounting differences stem from the fact that financial guarantee insurance issuers have additional products in which the insurer bears another party’s credit risk, such as credit guarantee insurance, credit default swaps, and other guarantees, that utilize different manners of accounting and reporting.

### **3. Draft 2005 Schedule M-3 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. Because the IRS has made several changes to the form, the newly released Schedule M-3 replaces all previously-issued versions. These changes include the requirement to report all adjustment amounts required to adjust worldwide income (loss) to net income of certain includible corporations in lines 5-10 of Part I and the clarification for the reporting of inter-company dividends in statutory income for insurance companies. 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 available this fall on the IRS's website. Finally, of importance to the insurance industry, the IRS is developing Schedules M-3 for Forms 1120PC and 1120L. It is expected that these forms will be effective December 31, 2005.

### **4. OECD Issues Draft on Allocating Profits to Insurance PEs**

On June 27<sup>th</sup>, the Organization for Economic Cooperation and Development ("OECD") released a discussion draft on the attribution of profits to a permanent establishment ("PE") as it relates to insurance. The discussion draft sets out the principles of the authorized OECD approach and provides guidance on how insurance companies should attribute profits to a PE. The draft's analysis is applicable to PEs and also to insurance activities of companies that operate through worldwide subsidiaries. In examining the proper treatment, the OECD requires a two-step process to determine which part of an insurance enterprise performs the various functions involved in the acceptance and management of insurance risks and should receive the associated insurance underwriting income. First, the activities of the PE should be determined as if it were a separate and distinct enterprise. Second, the profits of the PE are determined based on a comparability analysis. The draft discusses the fact that reinsurance raises questions of determining arm's length compensation based on the risks assumed. The OECD has requested that taxpayers submit comments no later than September 16, 2005. Comments were requested on specific topics, including the accuracy of the draft's explanation of the insurance business, the impact of foreign regulations on the business and how to determine the amount of surplus to be allocated to a particular location. The OECD is expected to finalize its position in 2007.

#### ***Circular 230 Disclosure:***

The material in this newsletter should not be construed as legal opinions of Scribner Hall & Thompson, LLP. Per Circular 230 requirements, you are advised that any discussion of Federal tax issues in this newsletter is not intended or written to be used, and cannot be used by you, to avoid penalties imposed under the Internal Revenue Code or to promote, market or recommend to another party any transaction or matter addressed herein.

**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) Scribner, Hall & Thompson, LLP, website: [www.scribnerhall.com](http://www.scribnerhall.com)**