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TAX ISSUES SUMMARY

July 27, 2005

***HIGHLIGHTS*:**

I.R.C. § 101 — COLI Class Action Settlement Payments Are Not Life Insurance Proceeds

In PLR 200528023 (Apr. 7, 2005), the IRS determined that distributions from a class action settlement fund used to pay claims of victims of alleged unlawfully purchased corporate-owned life insurance ("COLI") policies fail to qualify as life insurance proceeds and are not excludable from income under I.R.C. § 101. In reaching this conclusion, the IRS rejected arguments by the class members that the origin-of-the-claim doctrine requires the proceeds from the fund to retain the character of life insurance proceeds. Instead, the IRS determined that amounts received were in exchange for release of claims for amounts improperly converted by the corporation. See Policyholder Issues.

FASB Issues Exposure Draft to Revise Rules for Determining Tax Contingency Reserves

On July 14th, the Federal Accounting Standards Board ("FASB") released an exposure draft on the interpretation of FASB Statement No. 109, Accounting for Income Taxes, related to accounting for uncertain tax positions. The draft contains two standards in making this determination, each of which must be considered under the presumption that all uncertain tax positions will be challenged by tax authorities. First, the draft states that the benefit of a tax position may only be recognized when it is at least "probable" of being sustained when challenged. Second, the draft establishes a lower standard for derecognition of the benefit. Once recognized, a benefit will not be subject to derecognition until it becomes more likely than not that the tax position would not be sustained on audit. See Company Issues.

LEGISLATIVE

1. In General

On July 26th, the Senate Finance Committee marked up and approved the National Employee Savings and Trust Equity Guarantee Act ("NESTEG")(S. 219). Although earlier versions of this bill have been considered several times and failed to be enacted, there is renewed optimism for this bill. In addition to provisions addressing a perceived pension crisis for defined benefit plans (i.e., funding relief provisions, provisions for measuring pension assets and liabilities, cash balance plans, etc.), the bill continues to include a corporate-owned life insurance ("COLI") provision. NESTEG now provides that, if consent and notice requirements are met, death proceeds from a COLI contract will be tax free if the insured was: (1) actively employed within the 12 months preceding death; (2) a director at the time the policy was issued; or (3) a highly compensated employee at the time the policy was issued.

Sens. Baucus (D-Mont.) and Kyl (R-Ariz.) continue to work on the framework of a compromise regarding less-than-full repeal of the estate tax. According to Sen. Kyl, any compromise bill will retain the current law's step-up in basis, which states that inherited property will have a basis equal to its fair market value at the time of death. Other likely provisions for the compromise are a cut in estate tax rates, a large property exemption indexed to inflation, and retention of the provision that allows certain estates to pay tax bills over time. While work on the compromise continues, some Republican Senators are pushing hard for a vote in the Senate before the August recess for a full repeal of the estate tax, while others argue that such a vote could derail the compromise activities, which otherwise might be expected to come to a vote in September or October.

Finally, as of July 26th, it looks as though the conferees on both the energy bill (H.R. 6) and the highway bill (H.R. 3) may have completed their work, but information on the tax title in either bill is scarce. There appears to be some hope that the conference reports for both bills will be voted on before Congress' August recess.

2. Bill Introduced to Reduce Limitations on Life/Non-Life Consolidation

On June 22nd, Senate Finance Committee Member Bunning ®-Ky.) introduced S. 1293, a bill that would amend the Internal Revenue Code of 1986 to permit the consolidation of life insurance companies with other companies. The bill would repeal the requirement that non-life insurance companies must be members of an affiliated group for five years before losses may be used to offset life insurance taxable income. The bill also would phase out the limitation on the use of non-life losses that can offset life income, which is limited to the lesser of 35% of the non-life losses or 35% of the life taxable income. The bill was co-sponsored by Senate Finance Committee members Conrad (D-N.J.), Lott (R-Miss.), Smith (R-Ore.) and Lincoln (D-Ark.).

POLICYHOLDER ISSUES

1. I.R.C. § 101 — COLI Class Action Settlement Payments Are Not Life Insurance Proceeds

In PLR 200528023 (Apr. 7, 2005), the IRS determined that distributions from a class action settlement fund used to pay claims of victims of alleged unlawfully purchased corporate-owned life insurance ("COLI") policies fail to qualify as life insurance proceeds and are not excludable from income under I.R.C. § 101. In the facts of the ruling, families of deceased employees covered by COLI policies brought a class action suit against the corporate purchaser, claiming that the corporation did not possess the requisite insurable interest. During the course of litigation, the parties negotiated a settlement. Under the terms of the settlement, the corporation will set up a settlement fund based upon a set amount of money (about one third of the amount paid to the corporation under the policies). The settlement fund will be distributed to each class action plaintiff that files a valid claim. For a claim to be valid it must: (1) be related to a former covered employee of the corporation that is deceased; (2) be supported by proof of inheritance; and (3) be postmarked before the last day of the claims period. Each claimant will then be paid a percentage of the settlement fund calculated using the face amount of the COLI policies. The class members argued that the origin-of-the-claim doctrine requires the proceeds from the fund to retain the character of life insurance proceeds because the original amounts were death benefits held in trust by the corporation. The IRS rejected this argument and concluded that the class members were not being paid death benefits under the policies, but were being paid the amount of the settlement fund in exchange for the release of claims for amounts improperly converted by the corporation. Consequently, the IRS concluded that the settlement proceeds are not excludable from income under I.R.C. § 101.

2. I.R.C. § 7702 — Remittances Paid to Contract Owners Considered Part of Cash Surrender Value

In PLR 200528018 (Apr. 12, 2005), the IRS agreed that amounts paid to life insurance contract owners in the form of guaranteed and non-guaranteed remittances are part of the contracts' cash surrender values and determined that the company's not treating them as such was a reasonable error that could be waived. In the facts of the ruling, a stock life insurance company issued individual, non-participating, flexible premium life insurance policies. If a contract owner surrenders the contract, the company pays the owner an amount equal to the account value, less any outstanding policy indebtedness and surrender charges. Additionally, depending on how many months after issuance the contract is surrendered, the contract owner will receive either a guaranteed or non-guaranteed remittance, equal to a certain percentage of the premiums paid on the contract. The IRS considered the remittance to be part of the contract's cash surrender value under I.R.C. § 7702(f)(2)(A). However, the company's error in not treating the remittance as part of the contract's cash surrender value was a reasonable error and, because the company proposed a method of remedying the error that is reasonable, the error was waived under I.R.C. § 7702(f)(8).

COMPANY ISSUES

1. I.R.C. § 179 — IRS Issues Final Regulations on Expensing Tangible Property

The IRS issued final regulations (T.D. 9209) regarding the election to expense some tangible property and computer software under I.R.C. § 179. Under the regulations, the amount of I.R.C. § 179 property that may be expensed is increased from $25,000 to $100,000, and the ceiling at which deductions begin to diminish for total I.R.C. § 179 property placed in service is raised from $200,000 to $400,000. The regulations also provide that an I.R.C. § 179 election may be made or revoked on an amended federal tax return for a taxable year beginning after 2002 and before 2008; for taxable years beginning before 2003, a late I.R.C. § 179 election may be made or revoked by requesting a letter ruling. An I.R.C. § 179 election or revocation of an election may not be made in any other manner, and any revocation of an election is irrevocable.

2. I.R.C. §§ 481 and 832(b)(4) — District Court Holds Company Cannot Take Accounting Change Adjustment for Unearned Premium Reserve Transition

In American Family Mutual Insurance Co. v. United States, No. 04-C-0764-C (W.D. Wis. July 11, 2005), the United States District Court for the Western District of Wisconsin held that the exclusive nature of the six-year transitional adjustment procedure in the 1986 statutory amendment, reducing the amount of unearned premiums that can be used in calculating current unearned premiums to 80%, did not permit American Family Mutual to also make a statutory adjustment under I.R.C. § 481. In the facts of the case, American Family Mutual, a property and casualty insurance company, sought a refund of alleged overpayments of federal income tax, claiming that the 1986 Tax Reform Act's change in non-life insurers' method of calculating earned premium income entitled the company to a statutory adjustment of a previous tax year's taxable income, based on the change in method of accounting. In considering cross motions for summary judgment, the court concluded that American Family Mutual was not entitled to make an I.R.C. § 481 adjustment to a previous year's taxable income to account for the change in method of accounting. The court reasoned that the six-year transitional adjustment to unearned premiums specified by the Act was explicitly prospective and exclusive. As a result, the transition rule prevented duplication or omission of income and served the same purpose as the I.R.C. § 481 accounting change adjustment provision.

3. I.R.C. § 833 — BCBS Organization Conversion to For-Profit Status Is a Material Change

In TAM 200528026 (Mar. 16, 2005), the IRS determined that a Blue Cross and Blue Shield ("BCBS") organization's amendments to its articles of incorporation and issuance of stock to convert to a for-profit stock entity constituted a material change under I.R.C. § 833(c)(2)(C). The taxpayer was formed as a non-profit non-stock BCBS organization organized exclusively for charitable purposes. As part of a plan to convert to a for-profit stock corporation, the taxpayer amended its articles of incorporation to eliminate all references to charitable purposes. The conversion required the state legislature to enact several amendments to its code. In addition, the taxpayer sought and received approval for the conversion from the state insurance department, which approved the articles of incorporation. After the conversion, a new holding company was formed for the taxpayer and its

subsidiaries. The taxpayer then issued all of its stock to a subsidiary of the holding company. The holding company, in turn, issued stock to certain shareholders and policyholders of the taxpayer. The IRS National Office concluded that, although the taxpayer previously qualified as an existing BCBS organization under I.R.C. § 833(c)(2), any material change in operations or material change in structure would result in a loss of qualification. Under the facts, the IRS found that the taxpayer's conversion, which involved the issuance of stock, a change to its articles of incorporation and the manner in which it was governed under state law, constituted a material change in structure under I.R.C. § 833(c)(2).

4. FASB Issues Exposure Draft to Revise Rules for Determining Tax Contingency Reserves

On July 14th, the Federal Accounting Standards Board ("FASB") released an exposure draft on the interpretation of FASB Statement No. 109, Accounting for Income Taxes, related to accounting for uncertain tax positions. The draft proposes to change the rules for evaluating a tax benefit from an uncertain tax position can be recognized on a financial statement. The draft contains two standards in making this determination, each of which must be considered under the presumption that all uncertain tax positions will be challenged by tax authorities. The first standard relates to the recognition of benefits from uncertain tax positions. Under the new principles, the benefit of a tax position may only be recognized when it is at least "probable" of being sustained when challenged. Although not providing a safe harbor, the draft gives examples of facts and circumstances that might provide a probable level of confidence: (1) unambiguous tax law; (2) an unqualified "should" opinion from a tax advisor; (3) similar positions in prior years that have been obviously presented in the tax returns and accepted, or not disallowed or challenged, in examinations; and (4) similarity to legal positions that have been successfully resolved in litigation by another taxpayer. The amount of the reportable tax benefit should be the best estimate of the amount probable of being sustained; that is, the single most likely amount in a range of possible estimated amounts. If a tax position reported on a filed or amended tax return does not meet the probable criterion, a contingent tax liability reserve must be established, taking into account expected timing of cash flows to settle underpayment controversies. The draft states that if the probable standard is not initially met, the benefit may still be recognized in three instances: (1) if the probable threshold is subsequently met; (2) if the matter is resolved through negotiation or litigation; or (3) if the statute of limitations for examination has expired. The second standard relates to derecognition of a tax benefit previously recognized. Once recognized, a benefit will not be subject to derecognition until it becomes more likely than not that the tax position would not be sustained on audit. The proposed interpretation would be effective for the first fiscal year after December 15, 2005. All comments on the draft must be submitted no later than September 12, 2005.

5. Insurance Industry Examines Creation of Principle-Based Proposal for Reserves

The insurance industry is giving serious consideration to the creation of a "principle-based" reserving system for universal life contracts with secondary guarantees. Although regulators, insurers and actuaries "in principle" support the use of such a principle-based reserving system, as a practical matter, it appears that there is no agreement on how this should be achieved. For example, in June, the American Council of Life Insurers ("ACLI") generally endorsed the concept of insurance state regulators looking into a principle-based approach for reserving and determining risk-based capital. However, while recommending the adoption of Actuarial Guideline 38 ("AG 38"), which incorporates a more

formulaic approach without relying on actuarial judgment for reserving for universal life contracts with secondary guarantees, the ACLI also recommended that AG 38 have a sunset date of April 1, 2007, along with the addition of an actuarial calculation that would use a 7% load for the net single premium used in one of the steps in calculating reserves. At this point, AG 38 is considered a short-term solution, while a long-term solution is being developed. AG 38 has been forwarded to the executive committee of the National Association of Insurance Commissioners.

***Circular 230 Disclosure*:**

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