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TAX ISSUES SUMMARY

August 31, 2005

HIGHLIGHTS

I.R.C. § 402(a) — Final Rules for Contracts with Springing Cash Value

On August 26th, the IRS released final regulations under I.R.C. §§ 79, 83 and 402(a) (T.D. 9223) regarding the “fair market value” amount includible in a distributee’s income when life insurance contracts are distributed by a qualified retirement plan and regarding the treatment of property sold by a qualified retirement plan to a plan participant or beneficiary for less than fair market value, or when an employee is provided permanent benefits in combination with group-term life insurance or when a life insurance contract is transferred in connection with the performance of services. The new final regulations clarify that, in the case of the distribution of a life insurance contract, retirement income contract, endowment contract or any contract providing life insurance protection, the policy cash value and all other rights under the contract (including any supplemental agreements thereto, whether or not guaranteed) are included in determining the fair market value of the contract. Although the regulations do not provide a methodology for computing the fair market value, the preamble to the regulations says that the guidance in Rev. Proc. 2005-25, modifying Rev. Proc. 2004-16, still is applicable under the new final regulations. The final regulations became effective August 29, 2005, for benefits distributed or provided, or applicable transfers, on or after February 13, 2004. See Policyholder Issues.

2005-2006 Priority Guidance Plan Released

On August 8th, the IRS and Treasury released the 2005-2006 Priority Guidance Plan, listing 254 projects dealing with tax topics that affect individuals, corporations, charities, international transactions and employee benefit plans that the IRS and Treasury hope to accomplish during the next year. Of particular note for the insurance industry are: (1) Guidance on the taxation of certain annuity contracts under I.R.C. § 72; (2) Guidance on the qualification of certain arrangements as insurance; (3) Guidance on the taxation of variable contracts as described in I.R.C. § 817(d); (4) Final regulations under I.R.C. § 7702 regarding the attained age of the insured for purposes of testing the qualification of a contract as a life insurance contract (proposed regulations were published on May 24, 2005); and (5) Guidance under I.R.C. § 501(c)(15) on the calculation of gross receipts. See Company Issues.

LEGISLATIVE

In General

With Congress recessed for the month of August, it was “all quiet on the Washington, DC front.” With their return after Labor Day, the tax-writing committees of Congress can be expected to focus on the budget reconciliation bill and technical corrections. Despite all the debate about Social Security reform during the first half of the year, it is not clear how much will happen in that area beyond the debate.

POLICYHOLDER ISSUES

1. I.R.C. § 402(a) — Final Rules for Contracts with Springing Cash Value

On August 26th, the IRS released final regulations under I.R.C. § 402(a) (T.D. 9223) regarding the amount includible in a distributee’s income when life insurance contracts are distributed by a qualified retirement plan and regarding the treatment of property sold by a qualified retirement plan to a plan participant or beneficiary for less than fair market value. T.D. 9223 also contains final regulations under I.R.C. §§ 79 and 83 regarding the amount includible in income when an employee is provided permanent benefits in combination with group-term life insurance or when a life insurance contract is transferred in connection with the performance of services. The new final regulations state that a distribution of property by an I.R.C. § 401(a) plan, including any distribution of a life insurance contract, retirement income contract, endowment contract or any contract providing life insurance protection, must be taken into account by the distributee at fair market value. They clarify that, in the case of the distribution of a life insurance contract, retirement income contract, endowment contract or any contract providing life insurance protection, the policy cash value and all other rights under the contract (including any supplemental agreements thereto, whether or not guaranteed) are included in determining the fair market value of the contract. Although the regulations do not provide a methodology for computing the fair market value, the preamble to the regulations says that the guidance in Rev. Proc. 2005-25, modifying Rev. Proc. 2004-16, still is applicable under the new final regulations.

The new final regulations also retain the rules set forth in the 2004 proposed regulations under I.R.C. §§ 79 and 83, clarifying that fair market value is also controlling with respect to life insurance contracts under those sections. Thus, all the rights under the contract (including any supplemental agreements thereto, whether or not guaranteed) must be taken into account in determining the fair market value for purposes of determining the cost of permanent benefits under I.R.C. § 79 and for purposes of determining the value of the property transferred (e.g., in split-dollar arrangements) under I.R.C. § 83. The final regulations became effective August 29, 2005, for benefits distributed or provided, or applicable transfers, on or after February 13, 2004.

2. I.R.C. §§ 408 and 451 — Uncashed Check for IRA Distribution Currently Includible in Income

The Tax Court, in Millard v. Commissioner, T.C. Memo. 2005-192 (Aug. 8, 2005), determined gross income includes a distribution by check from an IRA even though the policyholder did not cash the check. In the facts of the case, a policyholder closed an IRA that he owned, and the bank issued a check to the policyholder and recorded the transaction as a premature distribution. The policyholder did not cash the check and presented the check to the bank for payment in a subsequent tax year. The bank canceled the original check and issued a second check, for the same amount, reflecting the current date. The IRS issued to the policyholder a notice of deficiency for the tax year in which the original distribution was received, but not cashed, plus the additional 10% early withdrawal tax under I.R.C. § 72(t). The policyholder filed a petition for a redetermination of the deficiency. In its memorandum opinion, the Tax Court rejected the policyholder's contention that, because the check was not endorsed or negotiated, the check and underlying funds remained the property of the bank and the mere receipt of the check did not constitute the receipt of income by the policyholder. Instead, the Tax Court determined that the check given to the policyholder was not subject to substantial limitation and therefore was constructively received on the date the check was provided, regardless of when it was cashed.

3. I.R.C. § 408 — IRS Issues Regulations on Conversions of a Non-Roth IRA Annuity to Roth IRA

The IRS has issued proposed and temporary regulations (REG-122857-05 and T.D. 9220, respectively) providing guidance concerning the tax consequences of converting a non-Roth IRA annuity to a Roth IRA. These new regulations provide that the full fair market value must be included in income upon conversion and also provide some standards for determining that fair market value based on how long the non-Roth IRA annuity has been in force and the premium payment requirements in effect. The regulations are effective August 19, 2005, and the IRS has requested that all comments be submitted by October 20, 2005.

4. I.R.C. § 512 — IRS Will Not Acquiesce on Payment of Administrative Costs with VEBA Income

The IRS has announced that it will not acquiesce in Sherwin-Williams Co. Employee Health Plan Trust v. Commissioner, 330 F.3d 449 (6th Cir. 2003). In the case, the Sixth Circuit reversed the Tax Court and held that passive income that a voluntary employees' beneficiary association set aside and actually spent on reasonable costs of administering health care benefits during the year did not count against the limit on set-aside amounts imposed by I.R.C. § 512(a)(3)(E).

COMPANY ISSUES

1. I.R.C. § 809 — IRS Releases Final 2004 Differential Earnings Rate

On August 10th, the IRS released Rev. Rul. 2005-58, 2005-36 I.R.B. ____, which sets forth the final differential earnings rate for 2004 for use by mutual life insurance companies to compute their

income tax liability for 2004. The IRS set the tentative 2004 differential earnings rate and the recomputed 2004 differential earnings rate for mutual life insurance companies at zero. Although I.R.C. § 809 has been repealed, it is still applicable for 2004.

2. I.R.C. § 1092 — IRS Rules Exchangeable Debt Is Position in Straddle

In TAM 200530027 (July 29, 2005), the IRS determined that certain debt instruments constitute a position under I.R.C. § 1092(d)(2) and that payments and accruals of interest and carrying charges are not deductible under I.R.C. § 263(g)(2)(A). Under the facts considered, a company issued exchangeable subordinate debt instruments that were indexed to a corporation's publicly-traded stock. Although the taxpayer was not required to hold the stock, it nonetheless held a substantial amount. The IRS determined that the instruments were part of a straddle with the corporate stock issued by the taxpayer and constituted a position under I.R.C. § 1092(d)(2). The IRS further concluded that the position qualified as a "position with respect to substantially similar or related property (other than stock)" held by the taxpayer. Finally, the IRS determined that the issuance of the stock was directly related to the carrying of the corporation's stock and that payments and accruals on the instruments are nondeductible interest and carrying charges under I.R.C. § 263. This was true despite the fact that the taxpayer was not required to hold the stock.

3. I.R.C. §§ 4251 and 4252 — Another Federal District Court Determines Telephone Excise Tax Does Not Apply to Certain Long Distance Calls

In Hewlett-Packard Co. v. United States, No. C-04-03832 RMW (N.D. Cal. Aug. 5, 2005), the United States District Court for the Northern District of California determined that the 3% telephone excise tax does not apply to long-distance telephone charges that do not vary by distance. This is another in a long line of victories for taxpayers. Last fall, in Notice 2004-57, 2004-35 I.R.B. 376, the IRS stated that it will continue to assess and collect the excise tax and that taxpayers' failure to pay the tax to their carrier may result in the imposition of penalties and interest. The IRS also released temporary, proposed regulations (T.D. 9149; REG-163409-02) detailing carriers' obligations to report the failure of their customers to pay the tax. It is expected that the IRS will appeal.

4. I.R.C. §§ 6662, 6662A and 6707A — IRS Issues Guidelines for Disclosure of Tax Shelter Penalties

In Rev. Proc. 2005-51, 2005-33 I.R.B. 296, the IRS provided guidance regarding who may be required to pay penalties under I.R.C. § 6662(h), 6662A or 6707A, including who may be required under I.R.C. § 6707A(e) to disclose those penalties on reports filed with Securities and Exchange Commission ("SEC"). I.R.C. § 6707A imposes a penalty of \$200,000 per transaction for failure to disclose a listed transaction, regardless of whether the underlying transaction results in an understatement of tax. The penalty cannot be waived with respect to a listed transaction. Moreover, I.R.C. § 6707A requires that payment of this penalty be disclosed on the company's next periodic report required under section 13 or 15(d) of the Securities and Exchange Act of 1934, regardless of the materiality of the penalty, and failure to disclose the penalty to the SEC is treated as a failure to disclose a listed transaction, resulting in the imposition of another penalty. The Notice clarifies the reports that must be used to make disclosures, the specific information that must be disclosed, and the deadlines by which disclosures must be made to the SEC in order to avoid additional penalties under I.R.C. § 6707A(e).

5. 2005-2006 Priority Guidance Plan Released

On August 8th, the IRS and Treasury released the 2005-2006 Priority Guidance Plan, listing 254 projects dealing with tax topics that affect individuals, corporations, charities, international transactions and employee benefit plans that the IRS and Treasury hope to accomplish during the next year. Of note for the insurance industry are: (1) Guidance on the taxation of certain annuity contracts under I.R.C. § 72; (2) Guidance on the qualification of certain arrangements as insurance; (3) Guidance on the taxation of variable contracts as described in I.R.C. § 817(d); (4) Final regulations under I.R.C. § 7702 regarding the attained age of the insured for purposes of testing the qualification of a contract as a life insurance contract (proposed regulations were published on May 24, 2005); (5) Regulations on the allocation of subpart F income; (6) Guidance on securities lending, the treatment of certain financial products, and other withholding tax guidance (proposed regulations under I.R.C. § 1441 were published on March 30, 2005); (7) Comprehensive final regulations under I.R.C. § 403(b) regarding tax-favored annuities purchased by I.R.C. § 501(c)(3) organizations or public schools (proposed regulations were published on November 16, 2004); and (8) Guidance under I.R.C. § 501(c)(15) on the calculation of gross receipts.

IRS Circular 230 Disclosure:

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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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