Scribner, Hall & Thompson, LLP

SUITE 1050
1875 EYE STREET, N. W.
WASHINGTON, D. C. 20006-5409

(202) 331-8585
FAX (202) 331-2032

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

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

TAX ISSUES SUMMARY

September 30, 2005

HIGHLIGHT:

IRS Defers Effective Date for Insurers' Filing of Schedule M-3

The IRS issued a news release deferring the required filing of Schedule M-3, Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More, by life and non-life insurance companies until taxable years ending on or after December 31, 2006. IR-2005-106 (Sept. 16, 2005). See Company Issues.

LEGISLATION

1. In General

Congressional tax writers may have planned to return from their August recess ready to act on budget reconciliation, technical corrections, and an "extenders package," but all such plans were put on hold in the wake of Hurricane Katrina (and then Rita). Since their early return from recess, tax writers have been occupied with developing tax provisions to provide relief for hurricane victims and incentives for redevelopment of the hurricane damaged areas. On September 23rd, the President signed into law the Hurricane Katrina Tax Relief Act of 2005, Pub. L. No. 109-73, which provides relief for affected individuals by, among other things, waiving the 10% tax on early IRA withdrawals, basing the 2005 child credit and earned income tax credit on the individual's 2004 income, and allowing an additional personal exemption of $500 for those who have been displaced. In the coming weeks, legislation providing longer-term economic relief to areas affected by Katrina is expected to be introduced. With attention focused on provisions (tax and otherwise) to provide hurricane relief, the budget reconciliation process has been pushed back to the point that many are predicting reconciliation activities will be set aside completely in favor of a continuing budget resolution. Likewise, Congressional attention to social security reform (if any) or tax reform now is not expected to occur until next year.

Hurricane Katrina also may have caused some additional interest in H.R. 2668, Policyholder Disaster Protection Act of 2005, which would permit insurers to use tax-deferred accounts to set money aside for payments following future natural disasters – or at least it has brought additional sponsors for the bill that was introduced in May. An NAIC working group proposal would allow the build up of

deductible reserves for future catastrophic losses, which would increase insurers' ability to respond to major disasters without risking insolvency. Critics of the proposal still argue that it is unlikely that such a change would increase the availability of catastrophic disaster insurance and that it would decrease tax revenues in a time of large budget deficiencies. A Congressional Research Service report was released detailing both sides of the debate.

2. Retirement Security for Life

On September 27th, Rep. Nancy Johnson (R-Conn.) introduced the Flexible Retirement Security for Life Act of 2005 (H.R. 819). This bill would allow the addition of a long-term care rider to an annuity contract, would clarify the treatment of a long-term care rider on a life insurance contract, and would allow a tax exclusion for lifetime nonqualified annuity payments.

COMPANY ISSUES

1. I.R.C. § 115 — Captive Insurance Company Income Excludable from Gross Income

The IRS, in PLR 200538004 (May 31, 2005), ruled that the income of a captive insurance company, pooling the insurance risks of a state's public utility companies, is excludable from gross income under I.R.C. § 115(1). In the facts of the ruling, an I.R.C. § 501(c)(6) membership association, formed as a purchasing group by a number of publicly-owned electric utilities to pool resources and obtain otherwise unavailable risk management and insurance services, created a captive insurance company that offers a variety of types of insurance. Membership in the company is offered only to association participants that are either a state or political subdivision and derive their income from the operation of a public utility and/or the exercise of any essential government function. The IRS examined whether the company's income is excludable from gross income under I.R.C. § 115(1), which provides that income derived from any public utility or the exercise of any essential government function and accruing to a state or political subdivision thereof is not included in gross income. The IRS determined that the company is performing an essential governmental function. Looking to the analysis in Rev. Rul. 90-74, 1990-2 C.B. 34, which ruled that the income of a similarly-formed organization is excludable from gross income so long as private interests do not participate in or benefit more than incidentally from the organization, the IRS concluded in PLR 200538004 that any private benefit is incidental to the public benefit and the income of the company accrues to a state or political subdivision of a state. Therefore, under I.R.C. § 115(1), the company's income is excludable from gross income.

2. I.R.C. § 501 — Workers' Compensation Organization Is Not Exempt

In PLR 200538039 (May 18, 2005), the IRS determined that an organization providing workers' compensation insurance to members of a certain type of state facility does not qualify as an organization exempt under I.R.C. § 501(c)(6) or 501(c)(27). In examining the facts presented, the IRS determined that the organization did not have the primary purpose of promoting a common interest for the improvement of business conditions, as required by I.R.C. § 501(c)(6) and the supporting regulations. Instead, citing Rev. Rul. 74-81, 1974-1 C.B. 135, the IRS concluded that the organization's provision of a cost-effective market for certain state facilities to obtain workers' compensation coverage is considered the rendering of particular services for individual persons, and the organization does not qualify for exemption under

I.R.C. § 501(c)(6). The IRS also concluded that the organization failed to qualify for exemption under I.R.C. § 501(c)(27) for a number of reasons: it did not demonstrate that it was established by the state (I.R.C. § 501(c)(27)(B)(i)); its membership restrictions prevented it from providing workers' compensation to "any" employee (I.R.C. § 501(c)(27)(B)(ii)); and its governing board was merely reviewed, rather than appointed, by the state (I.R.C. § 501(c)(27)(B)(iv)).

3. I.R.C. § 831 — Corporation Created to Provide Workers' Compensation to Certain Independent Contractors Is an Insurance Company

In PLR 200538012 (June, 20, 2005), the IRS ruled that a corporation created by a state to provide workers' compensation coverage to certain independent contractors demonstrates both risk shifting and risk distribution and qualifies as an insurance company under I.R.C. § 831. In the facts of the ruling, a particular industry in the state operates such that the Unit, which customers contact to obtain services, refers the contract to an independent contractor to perform the services. The contractor collects payment and remits the appropriate portion to the Unit. The state revised its workers' compensation laws and created a not-for-profit corporation to administer and pay workers' compensation benefits to these contractors. Under state law, the contractors are considered employees of the corporation for the purpose of workers' compensation. Consistent with relevant case law, the IRS examined whether the requisite risk shifting and risk distribution are present for the corporation's arrangement to constitute insurance. The risk dealt with in workers' compensation is the employer's potential liability to the employee, which is an economic risk. However, in the facts presented, the risk is that of the independent contractors, who would have no recourse against the Unit for injuries that occurred in performing the service were it not for the change in state law. This is an insurance risk, shifted from the contractors to the corporation and distributed across many similarly-situated contractors. Meeting these requirements, the IRS concluded that the arrangement between the contractors and the corporation is insurance. Therefore, the corporation qualifies as an insurance company within the meaning of I.R.C. § 831(c) for each taxable year that this arrangement accounts for more than half of its business.

4. I.R.C. § 842 — Domestic Asset/Liability Percentages and Investment Yields for Foreign Insurers Released

In Rev. Proc. 2005-64, 2005-36 I.R.B. 492, the IRS released the domestic asset/liability percentages and domestic investment yields for foreign life and property and liability insurance companies operating in the U.S., for use in computing their minimum effectively connected net investment income under I.R.C. § 842(b) for tax years beginning after December 31, 2003. The domestic asset/liability percentages are 121.7% for foreign life insurance companies and 173.6% for foreign property and liability insurance companies. The domestic investment yields are 5.5% for foreign life insurers and 3.7% for foreign property and liability insurers. The revenue procedure also provides instructions for foreign insurance companies to compute estimated tax liabilities.

5. I.R.C. §§ 1502 and 1503 — IRS Reviewing Obsolete Anti-Abuse Rule for Life-Nonlife Consolidated Groups

At a September 22nd American Law Institute and American Bar Association conference, an IRS person stated that obsolete consolidated return regulations are being reviewed. Under I.R.C. § 1503(c), a life insurance company joining a life-nonlife group generally is required to wait five years before joining

in filing a consolidated return. Treas. Reg. § 1.1502-47 shortens the waiting period, providing a series of conditions are met, including an expectation that the transaction will not result in a separation of profitable activities from loss activities. The conditions for shortening the waiting period, which were adopted prior to the 1984 change in the insurance tax regime, are based on the former three-phase structure for the taxation of life insurers. The IRS person indicated that, although the IRS cannot rule on the issue because the outdated regulations remain in effect, the IRS is looking at other ways to issue guidance in the future.

6. IRS Defers Effective Date for Insurers' Filing of Schedule M-3

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For comments or questions, or if you would like to receive the Tax Issues Summary via electronic mail, please contact Jennifer A. Gouker at (202) 434-9169 or jgouker@scribnerhall.com
Scribner, Hall & Thompson, LLP, website: www.scribnerhall.com