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TAX ISSUES SUMMARY

October 31, 2005

HIGHLIGHT:

Shelter Settlement Initiative Launched by IRS

On October 27th, the IRS announced a limited-time tax shelter settlement initiative, allowing taxpayers to settle on 21 types of listed and non-listed transactions. Announcement 2005-80, 2005-46 I.R.B. __. Under the terms of the settlement, the taxpayer will be required to pay 100% of the taxes and interest owed, and 25% to 50% of the penalties that the IRS would otherwise seek, depending on the transaction. Three categories of transactions are eligible for settlement. The second category, listed transactions subject to one-quarter penalty, includes specially designed life insurance policies in retirement plans, abusive treatment of Roth IRA accounts, and I.R.C. § 419A(f)(5) welfare benefit funds. To participate in the settlement initiative, taxpayers must file an election form before January 23, 2006. See Company Issues.

LEGISLATION

1. In General

With only three and a half weeks until its Thanksgiving recess, what will be accomplished of the tax agenda — budget reconciliation, a second round of Katrina tax relief, technical corrections, extender provisions (including the extension of the capital gains and dividends provision, pension reform) — is an open question. Senate Finance Chairman Grassley has talked about combining Katrina tax relief with the budget reconciliation tax provisions because of the time constraints, but House Ways & Means Chairman Thomas seems to be less than enthusiastic about that scenario. Chairman Grassley has proposed including business extender provisions as part of reconciliation, but Chairman Thomas has suggested that the recommendations of the tax reform panel would preclude Congress from passing the extenders this year (because the panel is expected to recommend the elimination of many of the extender

provisions as part of tax reform). So, even if the House and Senate each passes tax bills, conference of those bills can be expected to be difficult. However, because Congress seems to have even more non-tax agenda items to accomplish (e.g., the Senate has to consider and approve of another Supreme Court nominee), predictions are that Congress will stay in session until Christmas. If Congress stays in that long, it may well get some tax agenda items done as well.

2. Tax Reform Panel Expected to Recommend Two Options for Federal Tax Reform

Following October meetings, the President's Advisory Panel on Federal Tax Reform agreed that their final report, to be released on November 1st, will contain two options for federal tax reform: a simplified income tax and a hybrid consumption-based tax. Under both plans, the alternative minimum tax ("AMT") would be repealed. However, in an effort to offer simplification and to offset the revenue cost of repealing the AMT, the panel's recommendations are expected hit some hot buttons by suggesting that the current mortgage interest deduction be replaced with a home credit for 15 % of a capped amount of mortgage interest paid, that employer-provided health care coverage be capped, and that the deduction of state taxes be eliminated. The suggestion that three new types of tax-preferred savings vehicles — save at work accounts, save for retirement accounts, and save for family accounts — replace current savings vehicles has been greeted with mixed reviews as well. The simplified income tax would have four rates, 15 %, 25 %, 30 % and 33 %; there would be a 75 % exclusion for capital gains and a full exclusion for dividend income. It would collapse the standard deduction, personal exclusion, child tax credit, and head of household credit into a new family credit, and collapse the earned income tax credit and refundable child tax credit into a new work credit. For businesses, it would reduce the corporate tax rate to 32%, eliminate the corporate AMT, and generally eliminate tax on foreign operations.

The alternative hybrid consumption-based tax is described as a pro-growth model aimed at ensuring that corporate income is only taxed once. Tax benefits for housing, health care, and savings would be included on the corporate side. The key differences for individuals would be taxation of income at four rates (15%, 25%, 30% and 35%) and a 15% tax on dividends, capital gains, and interest. Although the goal of the pro-growth model "is to make sure that corporate income is taxed only once," this recommendation leaves many questions unanswered, such as transition issues and border adjustability.

POLICYHOLDER ISSUE

District Court Holds Company Had Insurable Interest in Lives Covered by COLI Policies

In a memorandum opinion, a United States District Court held that, under Colorado law, a company had an insurable interest in the lives of its employees and declined to rule on whether the interest the company paid on loans against the policies' cash value is deductible. Xcel Energy Inc. v. United States, No. 04-1449 (D. Minn. Oct. 12, 2005). The government filed a motion for summary judgment asserting that Xcel had no insurable interest in the lives of its employees; Xcel filed a cross-motion for partial summary judgment on the same issue. In the facts of the case, the predecessor to Xcel established a group life insurance program for its employees. Upon realizing it needed greater funding

for the program, the company identified employees most likely to benefit from the efforts to fund the program and purchased corporate-owned life insurance ("COLI") policies on these employees. Xcel informed the employees of the purpose of the new plan, and each employee gave written consent to participate in the plan. The determination of whether Xcel had an insurable interest in the employees is based on state law and, although the Colorado Supreme Court has not ruled on this precise question, the District Court concluded that it could make a reasonable determination of how the Supreme Court would rule. The court found that Xcel met the requirements laid out in case law: Xcel had a reasonable right to expect a benefit from each employee's continued employment; each employee consented to be insured; and each employee designated the company as the beneficiary. Concluding that Xcel had an insurable interest in the lives of its employees, the court denied the government's motion for summary judgment and granted the motion for partial summary judgment filed by Xcel.

Xcel also filed a motion for summary judgment claiming that it was entitled to deduct the policy loan interest as a matter of law, stating that it complied with the 4-out-of-7 rule and the investment in the policies had a practical, non-tax effect. In the facts of the case, after the initial payment of premiums on the policies, the company borrowed money from the policies and used the money to finance additional premiums owed on the policies in three of the subsequent seven years. The policy loan interest expenses were deducted on the company's tax returns. Case law provides that companies with COLI policies may deduct policy interest payments when (1) the premiums for at least four of the seven years of coverage are paid using unborrowed funds, and (2) the policies have a practical non-tax effect. While the parties agreed the 4-out-of-7 rule was satisfied, the government contended that the policies did not have a practical non-tax effect and were substantive shams, used solely to reduce Xcel's tax liabilities. To be considered a sham, it must be determined that the transaction is not motivated by an economic purpose outside of tax considerations and there must be no real potential for a profit. The court concluded that genuine fact issues remain as to whether the policies were substantive shams as a matter of law, and denied Xcel's motion for summary judgment.

COMPANY ISSUES

1. I.R.C. § 199 — Proposed Regulations Released on Domestic Production Deduction

The IRS and Treasury released proposed regulations (REG-105847-05) on the deduction relating to domestic production activities. Created by the Jobs Act, I.R.C. § 199 permits companies to deduct 3% of income from the domestic production activities for 2005 and 2006, increasing to 9 % by 2010. Qualifying activities include the manufacture of personal property such as clothing, goods and food; software development; film and music production; the production of electricity, natural gas or water; and construction, engineering and architecture services. The extensive proposed regulations provide clarifications and examples to determine companies' qualifying income. There is no indication that any income from "goods" produced by insurers would be subject to the deduction.

2. I.R.C. § 409A — Proposed Regulations Issued on Nonqualified Deferred Compensation Plans

The IRS issued proposed regulations (REG-158080-04) on the treatment of nonqualified deferred compensation plans under I.R.C. § 409A, expanding on previously-issued guidance and incorporating

taxpayer comments. Created under the Jobs Act, I.R.C. § 409A provides that all amounts deferred under a nonqualified deferred compensation plan are currently includible in gross income to the extent they are not subject to a substantial risk of forfeiture and not previously included in gross income. Nonqualified deferred compensation is defined in the regulations as amounts received from a plan under which a service provider has a legally binding right to compensation that has not been received, actually or constructively, and included in gross income and, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year.

The proposed regulations identify the plans and arrangements covered by I.R.C. § 409A, discussing how it applies to short-term deferrals, stock options and stock appreciation rights, restricted property, arrangements between partnerships and partners, foreign arrangements, and separation pay arrangements. The proposed regulations under I.R.C. § 409A are intended to cover split-dollar life insurance arrangements, despite comments requesting they be excluded. Specifically, I.R.C. § 409A should apply to split-dollar policies structured under the endorsement method, in which the service recipient is the owner of the policy, but enters into an arrangement irrevocably promising to pay premiums in future years. I.R.C. § 409A would not apply to a split-dollar arrangement that provides only death benefits for the service provider or under which the service recipient treats the assistance with paying for the policy as a loan. Additionally, the regulations detail the requirements for deferral elections and the timing for deferred compensation payments.

Although the regulations provide a one-year extension of the deadline for documentary compliance, to December 31, 2006, the deadline for opting out of deferral elections continues to be December 31, 2005. The proposed regulations are effective January 1, 2007, and may be relied on until final regulations take effect. Comments on the proposed regulations, including whether older split-dollar arrangements should be subject to the requirements of new I.R.C. § 409A, should be submitted by January 3, 2006, and a public hearing is scheduled for January 25, 2006.

3. I.R.C. § 412 — Examination of Abusive Plans Named Top Priority for IRS Employee Plans Branch

An IRS Employee Plans official, speaking at an October 12th press briefing, stated that Employee Plans' priorities for fiscal year 2006 include detecting and deterring plan abuses. Specifically, the IRS will continue its examinations of transactions using the tax-exempt status of retirement plans. One target of such examinations will be I.R.C. § 412(i) plans that exceed prescribed contribution limits and generate "enormous" deductions, and plans that reduce taxable income through distributions that minimize the insurance contacts' value. Another target of examinations will be S corporation employee stock ownership plans ("ESOPs") with structures "used to siphon off the profits of an operating company into a management company and then into an ESOP." The IRS's approach to deterring abusive plans will be to take a sampling of examinations involving the issue to devise a resolution strategy, expected in fiscal 2006, followed by aggressively seeking out for examination those that did not utilize the resolution strategy.

4. I.R.C. § 864 — Final Regulations Issued on Stock Held by Foreign Insurers

The IRS issued final regulations (T.D. 9226), which adopt without change the proposed regulations (REG-117307-04), providing that the exception to the asset-use test for stock will not apply

for purposes of determining whether the income, gain, or loss from portfolio stock held by foreign insurance companies constitutes effectively connected income. I.R.C. § 864(c)(2) provides rules to determine whether income effectively connected with the conduct of a trade or business in the United States includes income received by a foreign corporation from sources within the United States, or gain or loss from the sale or exchange of capital assets from sources within the United States. In making this determination, one factor taken into account is whether the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business ("the asset-use test"). Treas Reg. § 1.864-4(c)(2)(iii)(a) generally provides that stock of a corporation (whether domestic or foreign) is not an asset used in or held for use in the conduct of a trade or business in the United States for the purposes of determining the asset-use test. The new regulations provide that this general rule, excluding stock from the asset-use test, does not apply to stock held by foreign insurers unless their ownership interest equals or exceeds 10% by vote or value, a threshold set to distinguish portfolio stock held to fund policyholder obligations and surplus requirements from investments in a subsidiary. The IRS received only one comment on the proposed regulations, requesting further clarification on what constitutes an insurance company for federal income tax purposes, which the IRS determined was outside the scope of these regulations.

5. Shelter Settlement Initiative Launched by IRS

On October 27th, the IRS announced a limited-time tax shelter settlement initiative, allowing taxpayers to settle on 21 types of listed and non-listed transactions. Announcement 2005-80, 2005-46 I.R.B. __; see also FS-2005-17; IR-2005-19. Under the terms of the settlement, the taxpayer will be required to pay 100% of the taxes and interest owed, and 25% to 50% of the penalties that the IRS would otherwise seek, depending on the transaction. Three categories of transactions are eligible for settlement. The first category, listed transactions subject to one-half penalty, includes tax avoidance using inflated basis or offsetting foreign currency contracts, intermediary transactions, and lease strips. The second category, listed transactions subject to one-quarter penalty, includes specially designed life insurance policies in retirement plans, abusive treatment of Roth IRA accounts, and I.R.C. § 419A(f)(5) welfare benefit funds. Lastly, the third group includes abusive donations and manipulation of employee reimbursements. To participate in the settlement initiative, taxpayers must file an election form before January 23, 2006.

6. IRS Receives Comments on Proposed Definition of Insurance

The IRS has received numerous comments in response to its request for comments on additional guidance concerning the standards for determining whether an arrangement constitutes insurance (Notice 2005-49, 2005-27 I.R.B. 14). In the Notice, the IRS had 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. Issues raised in comment letters include: a state insurance department expressed a concern that the Code encourages purported insurance transactions that do not qualify as insurance at the state level to gain tax deductibility at the federal level, and recommended that captive cell arrangements, which lack risk pooling, should not qualify as insurance because they lack risk distribution; and industry groups

recommended that reinsurance transactions be evaluated on a contract-by-contract basis, avoiding the application of mechanical rules and checklists for measuring risk transfer.

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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
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