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TAX ISSUES SUMMARY

November 30, 2005

HIGHLIGHT:

I.R.C. §§ 817 and 7704 — RICs Supporting Variable Contracts Can Elect to Be Taxed as Partnerships

The IRS, in PLR 200544018 (June 1, 2005), ruled that a trust taxed as a regulated investment company ("RIC"), with two or more members having ownership interests ("units"), which is used as an investment vehicle for variable contracts, can elect to be taxed as a partnership and, because the units in the RIC will only be sold to segregated asset accounts of other insurance companies and not traded on an established securities market, the partnership will not be a publicly traded partnership under I.R.C. § 7704. The importance of the ruling for the life insurance industry lies in the beneficial effect that partnership tax treatment for check-the-box RICs will have on the computation of the company's share under I.R.C. § 812(a)(1) for the segregated asset account, and more specifically on the amount of company's dividends-received deduction. While the ruling concludes that the portfolios are eligible entities to check-the-box (or not) for partnership tax treatment, it leaves a lot of unanswered tax questions regarding the process of moving from RIC to partnership tax status. See Company Issues.

LEGISLATION

1. In General

Although both houses of Congress have dealt with the spending side of budget reconciliation, only the Senate moved forward on the tax side. On November 18th, the Senate passed the Tax Relief Act of 2005 (S. 2020), while the House postponed consideration of the Tax Relief Extension Act (H.R. 4297) until December. Although the House bill is expected to pass, some key differences between the houses may cause the conferencing process to outlast the short December session. For example, the Senate bill contains an alternative minimum tax ("AMT") patch, intended to shield middle class taxpayers from the AMT, but no extension of the lower rates for dividends and capital gains; the House bill contains a

2-year extension of 15% rate on capital gains and dividends, but has no provision for further AMT relief. It is generally understood that the tax number for budget reconciliation will not allow both. Although both bills contain a number of business "extenders," there are notable provisions unique to each. The much shorter House bill contains a 2-year extension of the Subpart F exemption for active financing and look-through treatment of controlled foreign corporations under foreign personal holding income rules; the Senate bill does not. The Senate bill contains hurricane tax reliefs provisions, a charitable giving incentive and reform package, as well as several revenue offsetting provisions; the House bill contains none of these. Even if the House passes its tax reconciliation bill in December, it seems unlikely that a final budget reconciliation bill will be enacted before 2006.

Throughout November, there has also been action on pension reform legislation. The Pension Security and Transparency Act of 2005 (S. 1783) passed the Senate on November 16th and includes changes to funding rules for single-employer defined benefit pension plans and changes to portability and distribution rules for defined contribution plans (e.g., allowing direct rollovers from retirement plans to Roth IRAs and eliminating higher early withdrawal tax on certain SIMPLE plan distributions). The bill would also limit the availability of tax-free corporate-owned life insurance proceeds. The House Ways and Means Committee reported out The Pension Protection Act of 2005 (H.R. 2830) and, like the reconciliation bill, pensions is another item on the December agenda for full House. Although Ways and Means considered provisions related to the addition of long-term care riders to annuities in combination insurance products and allowing conversions of existing life, annuity and long-term care products into products with such riders, these provisions were not in the bill as reported out of committee. The bill focuses on making permanent the pension and IRA provisions enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16), as well as the savers credit for elective deferrals and IRA contributions.

2. Tax Reform Panel Releases Written Recommendations

On November 1st, the President's Advisory Panel on Federal Tax Reform released their written report, following the oral outlines of possible recommendations that it had given previously. Since the release of the panel's recommendations, much of the commentary has focused on the proposal to replace current savings vehicles with three new types of tax-preferred savings vehicles: save at work accounts; save for retirement accounts; and save for family accounts. Under the panel's recommendations, not only would insurance products be grouped with other types of savings, but the benefits of life insurance and annuities could be greatly restricted, including the imposition of an annual contribution limit, tax on annual gains from annuities, and the elimination of the tax-free inside build-up in life insurance policies. With the panel's report being released late in 2005, whatever tax reform measures might be proposed by the President are not expected until next year.

POLICYHOLDER ISSUES

1. I.R.C. §§ 72, 401 and 6662 — Nonqualified Annuity Distributions Subject to Additional Tax

In Sadberry v. Commissioner, No. 04-61160 (5th Cir. Nov. 16, 2005), aff'g T.C. Memo. 2004-40, a United States Court of Appeals affirmed the Tax Court's holding that unreported distributions from nonqualified annuities were subject to additional tax and an understatement penalty. In the facts of the case, an individual purchased two nonqualified annuities, funded with initial contributions from his IRAs. Three years later, he formed a trust to help fund his child's education using distributions from the nonqualified annuities. Treating the distribution of the proceeds into a trust as a rollover, the taxpayer did not report pension and annuity income on his tax return. The Tax Court determined that rollovers, by definition, can occur only when distributions from one qualified annuity are deposited to another, and therefore no rollover could have occurred under these facts. The Tax Court also rejected the taxpayer's argument that detrimental reliance on the return instructions supported equitable estoppel of the IRS's claim and that both the 10% penalty on early distributions and the 20% penalty for the substantial understatement of income were applicable. The Fifth Circuit Court of Appeals affirmed the Tax Court's decision on all grounds.

2. I.R.C. § 412(i) — IRS Details Applicability of Settlement Initiative

In a November 17th webcast, IRS personnel discussed details about employee plan-related transactions subject to the recently-released tax shelter settlement initiative (Announcement 2005-80, 2005-46 I.R.B. 967). I.R.C. § 412(i) plans are included under the settlement program: if accumulated plan assets exceed the benefits payable; if life insurance policies built into the plan would pay more death benefits than the plan documents say the plan offers; or if the value of some participants' rights to buy life insurance contracts from the plan is much higher than other participants' contract purchase rights. The IRS may soon be sending correspondence to taxpayers with I.R.C. § 412(i) plans who may want to participate in the settlement program, even if they are not currently under examination.

3. I.R.C. §§ 213 and 223 — Guidance Issued on HSA Contributions by FSA Participants

In Notice 2005-86, 2005-49 I.R.B.___, the IRS clarifies the rules governing contributions to a health savings account ("HSA") by an individual covered by a flexible spending account ("FSA") and provides guidance on how employers can ensure HSA eligibility for employees. Under Notice 2005-42, 2005-23 I.R.B. 1204, the IRS provided that FSA participants have a grace period of 2½ months beyond the end of the calendar year to use their FSA balances for eligible health care expenses. Coverage under the FSA grace period may disqualify an individual from contributing to an HSA during that period. Notice 2005-86 explains that employers can amend FSAs to provide mandatory conversion to HSA-compatible FSAs for all participants, enabling all participants to become HSA-eligible during the grace period. The Notice also provides a transition rule, providing that for coverage years ending before June 5, 2006, otherwise eligible individuals may contribute to an HSA during an FSA grace period if there are no unused contributions in the individual's FSA account or the employer amends the FSA plan to provide that the FSA grace period does not cover any individual that elects high deductible health plan coverage.

4. I.R.C. § 223 — HSA Transition Relief Provided for Health Plans with Non-Calendar Year Renewal Dates

In Notice 2005-83, 2005-49 I.R.B. ___, the IRS provides transition relief to individuals covered by health plans that, in order to comply with state coverage mandates, fail to qualify as high-deductible health plans ("HDHPs"). Due to state mandates regarding the provision of benefits without regard to a deductible or with a deductible below the minimum annual deductible specified in I.R.C. § 223(c)(2), some health plans fail to qualify as HDHPs and the individuals covered under the plans are not eligible to contribute to HSAs. Notice 2004-43, 2004-2 C.B. 10, granted transition relief for such plans, allowing otherwise eligible individuals covered under the plans to contribute to HSAs until January 1, 2006. Notice 2005-83 extends the transition relief to non-calendar year plans that may continue to fail as HDHPs after January 1, 2006, due to a change in state law effective after the plans' renewal dates. The relief is available to non-calendar year plans with coverage periods of twelve months or less beginning before January 1, 2006, that otherwise would qualify as an HDHP except that they complied on their most recent renewal dates with state-mandated requirements. The transition relief is extended only until the earlier of the plan's next renewal date or December 31, 2006.

COMPANY ISSUES

1. I.R.C. § 451 — Nonrefundable Commitment Fees Determined to Be Put Option Premiums

In Federal Home Loan Mortgage Corp. v. Commissioner, 125 T.C. No. 12 (Nov. 21, 2005), the Tax Court determined that nonrefundable commitment fees paid under prior approval contracts by loan originators to the Federal Home Loan Mortgage Corporation ("Freddie Mac") are put option premiums, the tax treatment of which is unknown when they are received. In the facts of the case, loan originators (e.g., savings and loans organizations) could sell multifamily loans to Freddie Mac under its prior approval program. The program permitted originators to enter into a prior approval contract with Freddie Mac, under which it was not obligated to deliver the mortgage to Freddie Mac, but Freddie Mac was obligated to purchase the mortgage, priced with an established formula, if it was delivered by the originator. To obtain a prior approval purchase contract, an originator would submit an application to Freddie Mac, who would determine if the mortgage was acceptable. If so, Freddie Mac would execute a prior approval purchase contract, and the originator was required to return a commitment fee payable to Freddie Mac along with the executed contract. At issue was the tax treatment of the portion of the commitment fee that was nonrefundable. On its federal tax returns, Freddie Mac treated the nonrefundable portion of the commitment fees related to contracts on which the mortgage was delivered as premium received for writing put options. These amounts were not included in taxable income in the year of receipt, but were instead deducted from the cost basis of mortgages purchased under the prior approval contracts and were amortized into income over multi-year periods. If the mortgage on the contract was not delivered, Freddie Mac recognized the nonrefundable portion of the commitment fee in the taxable year in which the contract's option ended. After examination of the facts and relevant case law, the Tax Court determined that the contracts were options and Freddie Mac's treatment of the nonrefundable commitment fees as option premiums was proper.

2. I.R.C. §§ 832 and 846 — IRS Releases 2005 Unpaid Losses and Estimated Salvage Discount Factors

In Rev. Proc. 2005-72, 2005-49 I.R.B. ___, the IRS released loss payment patterns and discount factors for the computation of discounted unpaid losses under I.R.C. § 846 for the 2005 accident year. The IRS also released Rev. Proc. 2005-73, 2005-49 I.R.B. ___, which provides salvage discount factors to be used for computing the discounted estimated salvage recoverable under I.R.C. § 832 for the 2005 accident year.

3. I.R.C. §§ 4251 and 4252 — Despite Adverse Court Rulings, IRS to Continue Assessing Telephone Excise Tax

The IRS, in Notice 2005-79, 2005-46 I.R.B. 952, confirmed that it will continue to assess and collect the 3% telephone excise tax under I.R.C. § 4252, despite numerous court decisions ruling that the tax does not apply to long-distance telephone charges that do not vary by distance. Most recently, the United States Court of Appeals held that the tax does not apply to such charges in Office Max, Inc. v. United States, No. 04-4009 (6th Cir. Nov. 2, 2005).

4. I.R.C. § 6081 — Regulations Simplifying Automatic Filing Extensions Released

The IRS released proposed and temporary regulations (REG-144898-04; T.D. 9229) allowing many taxpayers to request six-month extensions without providing a signature or explanation. Focusing on the anomaly between the automatic six-month extension available to pass-through entities and other taxpayers' need to receive information from the pass-through entities to complete their own returns, the IRS and Treasury request comments on whether it may be appropriate for pass-through entities to have a shorter extension period than their partners or shareholders and whether a shorter extension would reduce overall taxpayer burden. All comments and requests for a public hearing must be received by February 9, 2006.

5. I.R.C. §§ 817 and 7704 — RICs Supporting Variable Contracts Can Elect to Be Taxed as Partnerships

The IRS, in PLR 200544018 (June 1, 2005), ruled that a trust taxed as a regulated investment company ("RIC"), with two or more members having ownership interests ("units"), which is used as an investment vehicle for variable contracts, can elect to be taxed as a partnership and, because the units in the RIC will only be sold to segregated asset accounts of other insurance companies and not traded on an established securities market, the partnership will not be a publicly traded partnership under I.R.C. § 7704. The facts of the ruling involve a managed open-end investment company organized as a series State business trust. The beneficial interests of the trust consist of transferable units in a series of portfolios, each with separate investments, which are used as investment vehicles for variable contracts of domestic insurance companies. While the insurance company issuing the variable contracts owns the units in the portfolio, the holder of a variable contract may allocate contract funds among sub-accounts that are identified with each portfolio and the contract values may reflect the investment return of the relevant portfolio. The taxpayer additionally made 13 representations concerning: (1) the current status of the business trust and the portfolios; (2) how the units of the portfolios will be "marketed;" (3) how the portfolios will be managed and the units accounted for; and (4) the fact that the segregated asset

accounts of the companies holding units in the portfolios will be diversified within the meaning of I.R.C. § 817(h). After examining the facts, and relying on the representations made by the trust, the IRS concluded that the portfolios are properly classified as business entities. The IRS further ruled that each portfolio would be classified as a partnership, under the authority of Treas. Reg. § 301.7701-3(b)(1)(a), which provides that a business entity is classified as a partnership unless it elects otherwise. Finally, the IRS determined that the each partnership would not be a publicly-traded partnership because, based on the representations made by the trust, the units will be owned by fewer than 100 domestic life insurance companies, the units are not traded on an established securities market and the units are not readily tradable on a secondary market. The necessity of having all the representations be true to arrive at the ruling's specific conclusions, given the analysis set forth, is not clear.

The importance of the ruling for the life insurance industry lies not in the code section addressed in the ruling, but in the beneficial effect that partnership tax treatment for check-the-box RICs will have on the computation of the company's share under I.R.C. § 812(a)(1) for the segregated asset account, and more specifically on the amount of company's dividends-received deduction. However, while the ruling concludes that the portfolios are eligible entities to check-the-box (or not) for partnership tax treatment, it leaves a lot of unanswered tax questions regarding the process of moving from RIC to partnership tax status.

6. I.R.C. § 831 — IRS Receives Comments on Determining Whether a Captive Arrangement Is Considered Insurance

Comment letters received by the IRS 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) continue to be released to the public. Among the issues on which the IRS requested comments was what factors should be considered in determining whether a cell captive arrangement constitutes insurance. A comment letter from the Captive Insurance Companies Association suggests that such a determination should be based on the facts and circumstances of the particular structure being reviewed on a cell-by-cell basis. Since segregation of risk exposure is the underlying purpose for creating cells, analysis of risk shifting and risk distribution should be done individually, respecting cell walls and considering contractual agreements between cells. The letter also recommends that tax considerations should not be the only determinants of whether a captive arrangement constitutes insurance.

7. Insurance Products Targeted in New Anti-Money Laundering Rules

Treasury's Financial Crimes Enforcement Network (FinCEN) issued final regulations under which insurers are required to file a form in connection with the purchase of an insurance policy subject to the reporting requirements. Insurers are required to report when cash of $5,000 or more, in premiums or potential payout, is provided in connection with a covered product. The reporting requirement applies to insurance companies offering covered products, including most life insurance products that have a cash value or investment features. The rule does not apply to the sale of term life, group annuities, group life insurance, health insurance, and other products that appear to be less useful to money launderers. The regulations also require insurance companies to: develop and implement a written anti-money laundering program; provide for independent testing to monitor and maintain the program; provide internal controls based on the company's assessment of the money laundering risk associated with its

products; designate a compliance officer; and provide for training of appropriate persons. Although brokers and agents are exempt from reporting requirements, brokers and agents must be integrated into the company's the anti-money laundering program.

8. FASB Adopts "More Likely than Not" Standard for Recording Tax Benefits from Uncertain Positions

At a November 22nd meeting, the Financial Accounting Standards Board ("FASB") announced that, to determine when tax benefits relating to uncertain income tax payment positions may be recorded, it tentatively adopted a "more likely than not" standard. This is a step back from the stricter "probable" standard proposed in its exposure draft of FASB Statement No. 109, Accounting for Income Taxes, released earlier this year. At its meeting, FASB reaffirmed its view that, in recognizing and measuring tax benefits related to a tax position, taxpayers should presume they will be examined by a taxing authority. The final interpretation of FASB Statement No. 109 is expected to be released in the first quarter of 2006.

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