

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

December 30, 2005

HIGHLIGHTS:

I.R.C. § 165 — Third Circuit Reverses and Remands Tax Court's Adverse Decision in the Capital Blue Cross Intangibles Case

In a significant victory for Blue Cross Blue Shield plans, the United States Court of Appeals for the Third Circuit reversed and remanded the Tax Court's decision in which it disallowed loss deductions for the loss of subscriber contracts. Capital Blue Cross v. Commissioner, No. 04-2645, 2005 WL 3274503 (3d Cir. Dec. 5, 2005). The Third Circuit held that the Tax Court applied an incorrect standard of value and held that it was appropriate for Capital Blue Cross to value the contracts at their "highest and best use." Moreover, the Third Circuit held that the Tax Court committed clear error in rejecting Capital Blue Cross' expert actuarial testimony on valuation issues and remanded the case with instructions for the Tax Court to find a value and for the government either to put on evidence of value or quantify its objections to Capital Blue Cross' valuation. See Company Issues.

I.R.C. §§ 6425 and 6655 — Proposed Regulations Issued on Corporate Estimated Tax

The IRS and Treasury issued proposed regulations (REG-107722-00) providing guidance for corporate taxpayers on the computation of estimated taxes, simultaneously withdrawing proposed regulations issued in 1984. The newly-proposed regulations advise corporate taxpayers how to calculate installment tax payments, based on a company's estimated annualized income, and are intended to target techniques used by taxpayers, particularly those computing estimated tax payments using an annualization method, to reduce or eliminate estimated tax payments for one or more installments for a taxable year. See Company Issues.

LEGISLATION

In General

Six months ago, one would have predicted that the only tax legislation likely to be enacted in 2005 would be the tax portion of the budget reconciliation bill. But then hurricane Katrina happened. When Congress recessed the first session, both houses had passed a second hurricane relief bill providing additional tax relief for rebuilding areas hit by the hurricane this fall, which President Bush signed into law on December 21st, and had passed the appropriations portion of the budget reconciliation bill. Although the House tried to move a stand-alone AMT relief bill, GOP leaders could not overcome opposition in the Senate to such a proposal. The conference on the tax cut portion of the reconciliation bills, for which the biggest difference between the House and Senate bills is the extension of reduced rates for dividends and capital gains in one and the extension of AMT relief in the other, now is predicted to be delayed until early February (after President Bush's State of the Union address). Likewise, passage of extensions for a group of other expiring provisions to provide simplification and certainty for individuals and businesses was delayed; Chairman Grassley and Senator Baucus of the Senate Finance Committee have filed a colloquy expressing their intention that these provisions would be extended without any intervening lapse as soon as Congress reconvenes next year.

POLICYHOLDER ISSUES

1. I.R.C. § 401 — IRS Provides Safe Harbor for Valuing Annuities in Roth IRA Conversions

In Rev. Proc. 2006-13, 2006-3 I.R.B. ____, the IRS provided safe harbor methods for determining the fair market value of an annuity contract in the conversion of a traditional individual retirement arrangement to a Roth IRA. Previous guidance (T.D. 9220, 2005-39 I.R.B. 596) requires that the fair market value of a converted individual retirement annuity or a converted individual retirement arrangement containing an annuity be determined at the time of conversion or distribution from the traditional IRA. This new revenue procedure provides that, until further guidance is issued, taxpayers may use a modified version of the method applied in Treas. Reg. § 1.401(a)(9)-6T, Q&A-12, to value annuity contracts that have not yet been annuitized. The revenue procedure also provides a simplified safe harbor for Roth IRA conversions occurring prior to 2006.

2. Court Denies Summary Judgment on Whether Annuity Valuation Tables Should Be Used to Value Decedent's Right to Receive Installments of Lottery Winnings

In Davis v. United States, No. 04-cv-273-SM (D.N.H. Dec. 19, 2005), the court considered cross motions for summary judgment on the legal question of how a decedent's lottery winnings (in the form of 10 annual payments) should be valued for estate tax purposes. The government argued that the right to ongoing lottery installment payments should be valued by reference to the annuity tables set forth for estate tax purposes. The decedent's estate argued that use of the annuity tables would distort the value of the asset because the right to receive future lottery payments is non-assignable, a fact which is not reflected in the tables and which makes the asset less valuable. The court agreed that the IRS annuity tables failed to take into account marketability, that marketability influences the fair market value and

that, when installment payments are non-marketable, that factor should be taken into account in determining fair market value. However, because the sufficiency of the proposed alternate valuation method and the “true” fair market value of the lottery winning installments were still disputed facts, the court denied both parties’ motions for summary judgment.

COMPANY ISSUES

1. I.R.C. §§ 162 and 195 — Recharacterization of “Start-Up” Fees Was Change in Method of Accounting

In TAM 200548022 (Aug. 23, 2005), the IRS concluded that a company’s recharacterization of fees, originally considered start-up expenditures under I.R.C. § 195, as ordinary and necessary business expenses under I.R.C. § 162 constituted an impermissible change in method of accounting. In the facts of the TAM, a parent corporation acquired two subsidiaries in a I.R.C. § 368 reorganization. On its consolidated return, the group elected I.R.C. § 195 treatment for all financial service, legal, consulting, and other fees incurred by the subsidiaries leading up to their acquisitions, and amortized the fees as start-up costs to be deducted over 60 months. The group then filed an informal refund claim, recharacterizing the fees as currently deductible under I.R.C. § 162, without filing a Form 3115, Application for Change in Accounting Method. The IRS determined that the treatment of the fees was a material issue involving the timing of the deduction, but not the taxpayer’s lifetime taxable income. Accordingly, the recharacterization of the fees constituted a change in method of accounting for which advance consent was required. The IRS further determined that, because certain fees did not meet the definition of start-up expenditures under I.R.C. § 195, they may not be amortized on the consolidated return and are instead allocable to each of the subsidiaries’ final returns.

2. I.R.C. § 165 — Third Circuit Reverses and Remands Tax Court’s Adverse Decision in the Capital Blue Cross Intangibles Case

In a significant victory for Blue Cross Blue Shield plans, the United States Court of Appeals for the Third Circuit reversed and remanded the Tax Court’s decision in which it disallowed loss deductions for the loss of subscriber contracts. Capital Blue Cross v. Commissioner, No. 04-2645, 2005 WL 3274503 (3d Cir. Dec. 5, 2005). In the Tax Court case, Capital Blue Cross sought to establish basis in the contracts as intangible assets under the stepped-up basis transition rule in section 1012(c)(3)(A) of the Tax Reform Act of 1986, Pub. L. No. 99-514. The stepped-up basis transition rule allows Blue Cross Blue Shield Organizations a fair-market value basis in all assets as of the day the organizations became taxable under the 1986 Act. At trial the government made a number of legal arguments to challenge the loss deductions in the context of the stepped-up basis transition rule. The Tax Court rejected all of the government’s legal arguments. However, the Tax Court held that, in determining the amount of its loss, Capital Blue Cross was required to value each insurance contract as if it were sold separately, and that the evidence presented by Capital Blue Cross did not meet this contract-by-contract valuation standard. On appeal, the Third Circuit held that the Tax Court applied an incorrect standard of value. Instead of valuing individual contract sales, a difficult and costly task, the Third Circuit held that it was appropriate for Capital Blue Cross to value the contracts at their “highest and best use” – a phrase usually associated with real estate valuation. A highest and best use valuation in this context would involve a reinsurance transaction in which a block, or blocks of contracts would be transferred. Moreover, the Third Circuit

held that the Tax Court committed clear error in rejecting Capital Blue Cross' expert actuarial testimony on valuation issues. The Third Circuit remanded the case with instructions for the Tax Court to find a value and for the government either to put on evidence of value or quantify its objections to Capital Blue Cross' valuation.

Two aspects of the Third Circuit opinion are particularly noteworthy. First, the Third Circuit held that, if a taxpayer's valuation evidence is reasonable, the government cannot prevail by simply critiquing the valuation without quantifying its objections or presenting its own valuation evidence. In such circumstances, at least in the Tax Court, the Third Circuit held that the court is required to find a value. Secondly, the Third Circuit held that a taxpayer can establish the total amount of loss deductions available in any single tax year under I.R.C. § 165 on an aggregate basis without ascribing a unique value to each individual asset. Both of these important precedents should help the Blue Cross Blue Shield industry finally to resolve the intangibles issue with the IRS.

3. I.R.C. §§ 167, 263 and 446 — Guidance Issued on Automatic Consent for Accounting Method Change Related to Capitalization of Intangibles

In Rev. Proc. 2006-12, 2006-3 I.R.B. ____, the IRS provides guidance on how taxpayers can apply for automatic consent to change their method of accounting under the final regulations on the capitalization of amounts paid to acquire or create intangible assets (T.D. 9107, 2004-7 I.R.B. 447). The new guidance applies to taxable years ending on or after December 31, 2005, and any earlier taxable year that is after the taxpayer's second taxable year ending on or after December 31, 2003. The revenue procedure also provides special procedures for taxpayers that changed their method of accounting under the final regulations but before guidance was released on how to do so with automatic consent.

4. I.R.C. § 362 — Old Revenue Ruling Allowing Zero-Basis Position for Some Stock Exchanges Is Revoked

Rev. Rul. 2006-2, 2006-2 I.R.B. ____, revokes Rev. Rul. 74-503, 1974-2 C.B. 117, which concluded that, in a transaction in which a corporation exchanges Treasury stock for the newly issued stock of another corporation, the corporation's basis in stock is determined under I.R.C. § 362(a) and the basis of both types of stock is zero. In revoking Rev. Rul. 74-503, the ruling states that the use of I.R.C. § 362(a) to calculate basis is incorrect, but provides no guidance on the correct determination of basis. The ruling further states that the IRS will not challenge positions taken under Rev. Rul. 74-503 for transactions occurring prior to December 20, 2005.

5. I.R.C. § 409A — IRS Waives Employer and Payer Reporting and Withholding Requirements for Calendar Year 2005

In Notice 2005-94, 2005-52 I.R.B. 1208, the IRS announced it is suspending the reporting and wage withholding requirements under I.R.C. § 409A for employers and payers for calendar year 2005. While employers and payers will not be required to report or withhold for calendar year 2005, they may be required to file corrected information returns and furnish corrected payee statements under future published guidance. Additionally, although I.R.C. § 409A provides that service providers must file a return and pay taxes due for amounts includible in gross income under I.R.C. § 409A, the IRS announced that it will not impose filing or payment penalties for calendar year 2005, although interest will continue to accrue. The IRS expects to issue guidance on the reporting and payment of taxes by service providers in 2006.

6. I.R.C. § 409A — IRS Provides Transitional Relief for Valuation of Outstanding Stock Rights

The IRS, in Notice 2006-4, 2006-3 I.R.B. ___, provided interim guidance on determining the fair market value of outstanding stock options and stock appreciation rights (collectively “stock rights”), and their exclusion from deferred compensation under I.R.C. § 409A. Generally, stock rights are excluded from coverage under I.R.C. § 409A if issued with an exercise price that cannot fall below the fair market value of the stock when it was granted and if the stock right does not contain any additional deferral feature. The Notice provides that, for stock rights issued prior to January 1, 2005, the fair market value may be determined using the rules governing incentive stock options under I.R.C. § 422, which provide that the exercise price will be deemed to be fair market value if the issuer attempted in good faith to set the exercise price at fair market value. For stock rights issued after January 1, 2005, taxpayers may make the determination of fair market value using any reasonable valuation method, the standard provided by Notice 2005-1, 2005-2 I.R.B. 274.

7. I.R.C. § 482 — IRS Extends Guidance for Valuing Cost-Sharing Arrangements

In Notice 2005-99, 2005-52 I.R.B. 1214, the IRS provided guidance on the valuation of stock-based compensation for purposes of qualified cost-sharing arrangements, extending an elective method of measurement and timing that may be used to account for stock options in cost-sharing agreements to another type of stock-based compensation commonly known as “restricted share units.” The Notice applies to stock-based compensation granted in tax years beginning after December 7, 2005, and may be applied retroactively to grants in open tax years beginning after August 25, 2003.

8. I.R.C. § 851 — Commodity-Index Derivative Contract Ruled to Not Be “Securities” for Purposes of Meeting the RIC Qualifying Income Requirement

In a news release (IR-2005-142) and Rev. Rul 2006-1, 2006-2 I.R.B. ___, the IRS indicated that it does not consider a commodity-index derivative contract to be a security, the income from which would help a fund to meet the RIC income requirement under I.R.C. § 851(b)(2). The news release explained that some mutual funds have entered into these derivatives to provide the fund shareholders with a total-return exposure to changes in the value of commodity indices because managers think that commodity exposure should be a component of investors’ overall portfolio, in part as a hedge against inflation.

Finding a definitional reference in I.R.C. § 851 to the Investment Company Act of 1940, but no conclusive authority whether commodity derivatives are securities under that Act, the ruling looks to legislative history and concludes that “security,” as used in I.R.C. § 851, was not intended to be interpreted so expansively as to include investment in commodity or commodity-index derivatives. Under I.R.C. § 7805(b)(8), the holding of the ruling will not be applied adversely for income amounts that a fund recognizes on or before June 30, 2006.

9. I.R.C. §§ 6011, 6111 and 6112 — Frequently Asked Questions about Tax Shelter Settlement Initiative Updated

On December 12th, the IRS updated its list of frequently asked questions related to the tax shelter settlement initiative set forth in Announcement 2005-80, 2005-46 I.R.B. 967. The updated listing is available on the IRS website at www.irs.gov/pub/irs-utl/general_faqs_121205.pdf.

10. I.R.C. § 6621 — Court Rules on Interest Netting Limitations Period

On remand from the Federal Circuit, the Court of Federal Claims, in Federal National Mortgage Association v. United States, No. 00-369T (Fed. Cl. Dec. 5, 2005), determined that the statute of limitations on assessment for the 1983 tax year of the Federal National Mortgage Association (“Fannie Mae”) was not open when I.R.C. § 6621(d) was enacted, and therefore Fannie Mae’s refund requested under the zero net interest rule was denied. In the facts of the case, Fannie Mae overpaid its taxes for 1974 and 1975, and the amounts were refunded in installments from 1994 through 1996, which were open years under the six-year statute of limitations applicable to overpayment interest. The overpayment periods overlapped with periods of underpayments for 1983 and 1986. In November 1988, Fannie Mae and the government executed a Form 872-A, Special Consent to Extend the Time to Assess Tax, indefinitely extending the limitations period for making assessments to Fannie Mae’s 1983 taxable year. In December 1990, the taxpayer and IRS executed a Form 870-AD, Offer of Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and of Acceptance of Overassessment, with respect to the 1983 tax year, under which the taxpayer reserved the right to file claims for refund related only to litigation pending in the Tax Court, and providing that if the plaintiff’s offer of compromise were accepted, the case could not be reopened. Finally, on or about May 1, 1995, the IRS decreased the tax owed by Fannie Mae for 1983 and issued a refund.

At trial, the factual dispute regarding whether the statutes of limitations on the underpayments were open on July 22, 1998 (the date of the enactment of I.R.C. § 6621(d)) was not resolved by the Court of Federal Claims, which instead ruled that only one of the overlapping periods was required to be open in order for interest netting to apply. Because the parties agreed that the overpayment period was open on July 22, 1998, the court ruled that Fannie Mae would be entitled to interest netting. In its holding, the court rejected the government’s position based on Rev. Proc. 99-43, 1999-2 C.B. 579, which states that both periods in question must be open for interest netting to occur. The lower court noted that Rev. Proc. 99-43 is not subject to deference under Chevron U.S.A. v. Natural Resources Defense Council, 467 U.S. 837 (1984). On appeal, the Federal Circuit agreed that Rev. Proc. 99-43 is not entitled to deference under Chevron, but disagreed with the lower court’s decision because the lower court did not examine whether the United States had waived sovereign immunity, a jurisdictional issue that neither the taxpayer nor the government had raised. The appellate court determined that, because the case involved a time bar under the statute of limitations, sovereign immunity could only be waived to the extent the statute was

clear. Concluding that I.R.C. § 6621 was not clear, the appellate court remanded the case to the Court of Federal Claims to determine whether the statute of limitations for the underpayment period had closed.

On remand, the Court of Federal Claims examined whether the statute of limitations for the filing of a refund claim for Fannie Mae's 1983 tax year remained open on July 22, 1998. Concluding that the issue turned on whether the indefinite extension of time to assess under Form 872-A was in effect as of that date, the court outlined the three ways the indefinite extension of the period of limitations could have ended: (1) on the date a Form 872-T, Notice of Termination, was issued by the taxpayer or IRS; (2) on the date the IRS issued of a notice of deficiency; or (3) on the assessment date of an increase in tax or the overassessment date of a decrease in the tax that "reflects the final determination of tax and final administrative appeals consideration." The government contended that the abatement of tax that occurred in 1995 established the final resolution of issues reserved on the Form 870-AD and reflected the final determination and appeals consideration for Fannie Mae's 1983 taxable year. The court concluded that the language used the Form 870-AD demonstrated that the tax liability established following the audit and appeals process would be a final, agreed-upon adjustment. Based on these facts, the court concluded that the period of assessment of tax, as agreed to in Form 872-A, ended 90 days after the May 1, 1995 refund date. Having determined that the statute of limitations for Fannie Mae's 1983 taxable year was closed as of July 22, 1998, the court ruled that Fannie Mae was not entitled to the netting of interest payments tied to its 1974 overpayments and its 1983 underpayments.

11. I.R.C. §§ 6425 and 6655 — Proposed Regulations Issued on Corporate Estimated Tax

The IRS and Treasury issued proposed regulations (REG-107722-00) providing guidance for corporate taxpayers on the computation of estimated taxes, simultaneously withdrawing proposed regulations issued in 1984. The newly-proposed regulations advise corporate taxpayers how to calculate installment tax payments, based on a company's estimated annualized income. According to the IRS and Treasury, the newly-proposed regulations are intended to target techniques used by taxpayers, particularly those computing estimated tax payments using an annualization method, to reduce or eliminate estimated tax payments for one or more installments for a taxable year. Taxpayers may rely on the newly-proposed regulations for taxable years beginning on or after December 8, 2005. Comments are due by February 22, 2006, as are outlines of topics to be discussed at a March 15, 2006 public hearing.

12. IRS Releases Schedules M-3 for Insurance Companies and S-Corporations

On December 13th, the IRS released new draft Schedules M-3, Net Income (Loss) Reconciliation for Companies with Total Assets of \$10 Million or More, along with instructions, for corporations that file Forms 1120PC, 1120L and 1120S. When finalized, the schedules will apply to tax years ending on or after December 31, 2006. Of concern to insurers is the fact that guidance is still needed on how to reconcile the differences between the Schedules M-3 for parent companies that file Form 1120, but own subsidiaries that file Form 1120PC or 1120L. The IRS requests comments on the new forms by February 10, 2006, and expects to finalize the form next summer.

13. IRS CAP Pilot Program Formally Announced

The IRS, in Announcement 2005-87, 2005-50 I.R.B. 1144, formally announced its Compliance Assurance Process (CAP) pilot program for large businesses. The year-old program is designed to identify and resolve issues prior to the filing of a tax return, thereby reducing the need for post-filing audits and reducing taxpayer uncertainty regarding the treatment of transactions. Following post-filing reviews with several large business taxpayers that participated in the CAP pilot program for tax year 2005, the IRS will evaluate the program, including possible adjustments and whether the program should be made permanent.

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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