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TAX ISSUES SUMMARY

January 31, 2006

HIGHLIGHT:

I.R.C. § 847 — IRS Releases Field Directive on Treatment of Special Loss Discount Accounts

In a January 13, 2006 field directive issued by the IRS's Large and Midsize Business Division, direction is provided on the background, identification, examination and reconciliation of I.R.C. § 847 special loss discount accounts. The directive includes guidelines for IRS personnel examining insurance company returns involving the election to make special estimated tax payments under I.R.C. § 847, including instructions regarding more technical issues. See [Company Issues](#).

LEGISLATION

1. In General

With the Senate focused on the nomination of Judge Alito to the Supreme Court and the House just now reconvening, work on tax bills has been at a standstill. Following the passage of the appropriations portion of the budget reconciliation bill in both houses in December, conferees for the tax cut portion of the reconciliation bills are expected to be named in early February. The biggest difference between the House and Senate tax reconciliation bills is the extension of reduced rates for dividends and capital gains in House bill and the extension of AMT relief in the Senate bill. There is some expectation that the dividends and capital gains provision will remain part of reconciliation, while the AMT relief will be left for stand-alone legislation that might be expected to pass both houses of Congress without the reconciliation protections.

Other tax legislation expected to have both House and Senate attention in early 2006 is the pension reform act (H.R. 2830). This legislation is of interest to insurance companies because it contains provisions that would clarify the treatment and enhance the opportunity for combination insurance products providing long-term care insurance coverage, specifically as part of an annuity contract. The House passed the bill in December, and it has been placed on the calendar in the Senate.

It also should be noted that, although the Gulf Opportunity Zone Act of 2005 (signed into law on December 22) provides additional regulatory authority for identified straddles, it does not address the concerns raised by the life insurance industry. ACLI reports that it has a commitment from Capitol Hill staff to address the industry's concerns in the next technical corrections bill.

POLICYHOLDER ISSUES

1. I.R.C. §§ 61 and 817 — Addition of New Investment Options Does Not Cause Segregated Account Assets to Be Owned by Contract Holder

In PLR 200601006 (Sept. 30, 2005), the IRS ruled that the addition of new investment options, with investment strategies based on the contract holder's year of retirement, to existing fund options would not cause the assets in the segregated asset accounts for diversified variable contracts to be treated as owned by the contract holders and the earnings on assets in the segregated accounts to be treated as income of the contract holders of the variable contracts. In the facts of the ruling, a stock life insurance company issues deferred and immediate variable annuity contracts. Portions of the premiums allocated to variable investment options by the contract owners are held in a separate account by the insurer and are allocated to sub-accounts that invest in regulated investment companies ("existing funds") that correspond with the variable investment options. All the segregated asset accounts are adequately diversified under I.R.C. § 817(h) and Treas. Reg. § 1.817-5. The insurer will establish new sub-accounts, each representing investment strategies based on the approximate year of a contract holder's retirement, that will invest in different regulated investment companies ("new funds"). After initially investing solely in existing funds, the assets of the new funds may, at the sole discretion of an investment manager, also be invested in funds that are available to investors other than through the purchase of a variable contract. To identify the owner of the new sub-account assets, the IRS stated it must examine the relevant facts and circumstances. The IRS concluded that contract owner does not have sufficient control of the separate account or any sub-account assets to be considered the owner of those assets for federal income tax purposes. Under the facts presented, and assuming the contracts continue to satisfy the diversification requirements of I.R.C. § 817(h) and Treas. Reg. § 1.817-5, the assets of the new sub-accounts will be treated as owned by the insurer, and the contract owners will not be required to include earnings on the assets held in the new sub-accounts in income under I.R.C. § 61(a).

2. I.R.C. §§ 61 and 817 — Insurer Is Not Owner of Assets Underlying Group Variable Annuity Contracts Issued Through Foreign Branch

In PLR 200601007 (Sept. 30, 2005), the IRS applies investor control analysis to a group variable annuity contract, which otherwise does not have required distribution-at-death rules, does not qualify as a variable contract or a pension plan contract and is not diversified, and concludes that the insurance company is not considered the owner of the investments funding the obligations under the contract. In

the facts of the ruling, a domestic life insurance company issues group variable annuity products through a foreign branch office. The contracts are issued to trustees and sponsors of pension plans established under foreign law and are used to fund obligations of various types of defined contribution pension plans. The assets supporting the contracts are held in a separate account, and although the plans are the contract holders, the insurer separately accounts for each plan member's contract amount. As directed by the plan members, the contract amounts are allocated into investment options that are the equivalent of sub-accounts of the separate account. Each sub-account invests in three types of assets, all of which are available for purchase directly by the public, without the purchase of a variable contract. In addition, the insurer represents that the contracts do not comply with I.R.C. § 72(s); do not qualify as variable contracts for purposes of I.R.C. § 817(d); are not pension plan contracts under I.R.C. § 818(a); and do not comply with the diversification requirements of I.R.C. § 817(h). After discussing IRS guidance and case law regarding when an investor in a contract has sufficient control over the underlying investment to be treated as the owner of those investments, the IRS concludes that the life insurer will not be considered the owner of the underlying investment assets for federal income tax purposes.

3. I.R.C. § 264 — Court of Appeals Reverses Dow Chemical and Disallows COLI Interest Deductions

In Dow Chemical Co. v. United States, No. 01-10331 (6th Cir. Jan. 23, 2006), the United States Court of Appeals for the Sixth Circuit reversed a district court decision and disallowed Dow's deductions on interest on loans used to pay for corporate-owned life insurance ("COLI"). In the facts of the case, Dow used policy loans to pay the premiums on its COLI plans for years one through three and then years eight and nine, and used partial withdrawals to pay premiums in years four through seven. In addition to holding that the COLI plans satisfied the 4-out-of-7 safe harbor of I.R.C. § 264, the trial court held that the plans were not economic shams because tax considerations were not the primary reason for Dow's purchase of the policies. As a result, the court concluded that Dow was entitled to the refund on the interest on the policy loans, plus interest. On appeal, the court examined whether Dow's COLI plans had a nontax benefit or were economic shams. The court identified three possible nontax benefits relevant to the economic substance analysis of COLI plans: positive cash flow, inside buildup, and mortality gain. The court found that positive cash flow and inside buildup would only exist if Dow were to make large cash contributions in the future, but Dow had no obligation to make such contributions and such contributions would be a "drastic departure" from past treatment of the plans. Thus, the court concluded that positive cash flow and inside buildup were not present, and the design of the plans actually reduced mortality gains. Without demonstrating any of these recognized nontax benefits, the court concluded that Dow's COLI plans lacked economic substance and the IRS had properly disallowed the interest deductions.

4. I.R.C. § 409A — IRS Provides Guidance on Treatment of Stock Appreciation Rights

In an information letter, INFO-2005-0202 (Dec. 20, 2005), the IRS provided information on the application of I.R.C. § 409A to stock appreciation rights ("SARs"). I.R.C. § 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are includible in gross income to the extent that they are not subject to a substantial risk of forfeiture and were not previously included in gross income. Notice 2005-1, 2005-2 I.R.B. 274, clarified what types of arrangements were considered nonqualified deferred compensation. Under the legislative history and the

Notice, stock options and certain SARs that “closely resemble[] stock options” are excluded from coverage under I.R.C. § 409A. A taxpayer requested guidance on the impact of I.R.C. § 409A on his control of his financial assets in light of IRS guidance (Notice 2005-1) and the I.R.C. § 409A proposed regulations (REG-158080-04). In its response, the IRS reiterated the position provided in the proposed regulations. Despite having received many comments criticizing its position on the application of I.R.C. § 409A to SARs, particularly regarding the application of I.R.C. § 409A to SARs issued by non-publicly traded corporations but not to those issued by publicly traded corporations, the IRS states that the exclusion provided in the proposed regulations applies to SARs that are substantially similar to stock options that meet the exclusion requirements, regardless of whether they are issued on stock that is publicly traded or whether the employer settles the SARs in stock or cash.

5. Class Certification Denied Without Prejudice in Insurance Demutualization Refund Case

In Fisher v. United States, the Court of Federal Claims determined that a trustee requesting a refund of tax paid on stock received in a demutualization transaction failed to meet the class certification requirements, denying his motion for class certification. In the facts of the case, the plaintiff owned a life insurance policy issued by an insurer that later underwent a demutualization. As a result, the plaintiff received and subsequently sold shares in the stock insurance company. The plaintiff reported the full amount of the proceeds from the sale as income and paid the resulting tax. The plaintiff’s refund claim, which argued that the treatment of such distributions as capital gains with a zero basis was incorrect and unsupported, was rejected by the IRS. The plaintiff then filed suit and a motion for class certification including all taxpayers who owned life insurance policies during a demutualization and paid tax on either cash received in lieu of stock or on the disposition of the stock received in the demutualization transaction and had a refund claim for such amounts denied. The government filed a motion in opposition, asserting that the Court of Federal Claims generally disfavors class actions except in extraordinary cases. The court rejected the government’s contention, which was based on the court’s rules as in effect prior to a 2002 revision that changed the relevant rule to mirror the Federal Rules of Civil Procedure. The court closely examined the class certification requirements of Fed. R. Civ. P. 23, which include prerequisites to a class action and requirements to maintain a class action. Describing how the plaintiff failed to satisfy a number of these requirements, the court did not grant class certification. However, the court denied the motion without prejudice and permitted the plaintiff to present additional evidence should the plaintiff choose to file a renewed motion.

COMPANY ISSUES

1. I.R.C. § 501(c)(15) — Insolvent Non-Life Insurance Company Remains Exempt under Transition Rule

In PLR 200552021 (Oct. 7, 2005), the IRS determined that an insolvent insurance company retained tax-exempt status under I.R.C. § 501(c)(15) under the provisions of the special transition rule in The Pension Funding Equity Act, Pub. L. No. 108-218 (2004)(“Act”). In the facts of the ruling, an insurance company previously granted tax-exempt status under I.R.C. § 501(c)(15) is currently being liquidated in receivership. The IRS considered whether the insolvent insurer retains its exempt status.

The Act amended I.R.C. § 501(c)(15), providing exemption for non-life insurance companies if the company's gross receipts do not exceed \$600,000 and more than 50% of such gross receipts consist of premiums. Under the factual representations provided by the receiver, the company did not receive premiums and therefore fails to meet the current requirements. However, the Act also provided a special transition rule regarding exemption for certain insurance companies in receivership or liquidation. Under the transition rule, there is a two-step process for determining whether an insurer qualifies for exemption: the insurance company's taxable year including April 1, 2004, must meet the requirements of I.R.C. § 501(c)(15)(A) as in effect for the last taxable year beginning before January 1, 2004; and the insurance company must be in a receivership, liquidation, or similar proceeding under the supervision of a state court as of April 1, 2004. Based on the representations and information in the submission, the IRS determined that both these qualifications were met. The transition rule will continue to apply, and the insurance company may remain exempt, until taxable years beginning after the date the state court proceeding ends or December 31, 2007, whichever is earlier.

2. I.R.C. § 847 — IRS Releases Field Directive on Treatment of Special Loss Discount Accounts

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3. I.R.C. § 954 — IRS Issues Regulations on CFC's Distributive Share of Partnership Income

The IRS issued proposed, temporary and final regulations (REG-106418-05; T.D. 9240) providing guidance on whether the distribution of partnership income by a controlled foreign corporation ("CFC") is excluded from foreign personal holding company income under I.R.C. § 954(i). The regulations will affect CFCs that are qualified insurance companies, have an interest in a partnership, and possess U.S. shareholders. They provide that a CFC's distributive share of partnership income qualifies for the I.R.C. § 954(i) exception if the CFC is a qualifying insurance company and the income would have been qualified insurance income if received by the CFC directly. Comments on the proposed regulations are due by April 17, 2006, and the rules are effective January 17, 2006.

4. I.R.C. §§ 6011 and 6111 — Book-Tax Difference Removed from List of Reportable Transactions

With the release of Notice 2006-6, 2006-5 I.R.B.____, and IR-2006-6 (Jan. 6, 2006), the IRS and Treasury announced the elimination of the book-tax difference category of reportable transactions. Based on a review of Forms 8886, Reportable Transaction Disclosure Statement, and Schedules M-3, Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More, the IRS and Treasury determined that the information provided by the Schedule M-3, which will be required for tax year 2006 and later, make separate reporting of such book-tax difference unnecessary. Such transactions are no longer subject to the tax shelter disclosure and list maintenance requirements as of January 6, 2006. Until regulations implementing the change are released, taxpayers and materials advisors may rely on Notice 2006-6.

5. I.R.C. § 6621 — Tax Court Determines Compound Interest on Overpayment Interest Balance Accrues at Reduced Rate

In a pair of opinions, the Tax Court determined that a taxpayer's accrued overpayment interest balance as of December 31, 1994, the effective date of the GATT amendment, will accrue interest at the reduced overpayment interest rate to the extent it relates to corporate overpayments exceeding \$10,000. In the facts of State Farm Mutual Automobile Insurance Co. v. Commissioner, 126 T.C. No. 2 (Jan. 17, 2006), the IRS issued refunds related to a payment in excess of \$10,000 and related interest on a single tax year, following a decision entered by a United States Court of Appeals on appeal from the Tax Court. Upon receipt of the refund, State Farm filed a motion for redetermination of interest owed beginning on January 1, 1995, on previously accrued interest attributable to an overpayment of tax in excess of \$10,000. In the facts of Exxon Mobil Corp. v. Commissioner, 126 T.C. No. 3 (Jan 17, 2006), the taxpayer reported overpayments in excess of \$10,000 on its timely-filed tax returns for six earlier years. Upon audit, the IRS determined substantial deficiencies for these same years, but, through the course of audits, administrative appeals and litigation, Exxon Mobil made a number of substantial advance payments of taxes and interest with respect to each of those deficiencies, such that an overpayment in excess of \$10,000 existed for each tax year. Having settled all the underlying tax issues for those years, the issue presented was the rate of overpayment interest to which Exxon Mobil is entitled.

Both cases turned on the application of the GATT (General Agreement on Tariffs and Trade) amendment to I.R.C. § 6621, enacted by the Uruguay Round Agreements Act, Pub. L. No. 103-465 (1994). I.R.C. § 6621(a)(1) provides that the interest rate on an overpayment of tax is the federal short-term rate plus an additional 2 percentage points. However, when the overpayment of tax by a corporation exceeds \$10,000, the interest rate shall be the short-term rate plus 0.5 percentage point. In both cases, there was no dispute over the application of the reduced rate of interest accrued on the overpayments of tax, which exceeded \$10,000, but on whether the balance of interest accrued on the overpayment as of December 31, 1994, (the effective date of the GATT amendment) was subject to the reduced interest rate. The taxpayers argued that the reduced rate was applicable only to overpayments of tax, not the related accrued interest, an argument that the court rejected, stating that once the reduced rate is triggered, any and all further interest related to or associated with that excess corporate payment is to accrue at the reduced rate. Additionally, the taxpayers contended that the regular rate, not the reduced rate, should apply to the first \$10,000 of the overpayment. The court also rejected this argument, adopting the stance that the \$10,000 threshold is met based a single, cumulative overpayment amount for

the taxable year, and once that threshold is reached and the reduced rate is triggered, any and all further interest related to or associated with that excess corporate payment is to accrue at the reduced rate.

6. FASB Delays Effective Date for Rules on Uncertain Tax Positions

Following its January 11th meeting, the Financial Accounting Standards Board (FASB) announced a one-year delay in the application of its forthcoming standards for determining when tax benefits relating to uncertain income tax payment positions may be recorded, under FASB Statement No. 109, making it effective for fiscal years beginning after December 15, 2006, or January 1, 2007, for companies reporting on a calendar-year basis. Despite the exposure draft stating that the benefit of a tax position may only be recognized when it is at least “probable” of being sustained, FASB reduced the threshold in November, tentatively adopting a “more likely than not” standard. FASB provided further insight into the application of the new standard, stating that interest and penalties will be recognized in the period they have been incurred. Deciding against prescribing a classification of interest and penalties, FASB decided to treat the classification as a policy election that should be disclosed in an enterprise’s summary of significant accounting policies along with the amount of interest and penalties recognized in the financial statements. Additionally, FASB provided that in the subsequent recognition of an uncertain tax position, companies must utilize a best estimate of the tax position at each reporting date.

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