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TAX ISSUES SUMMARY

February 28, 2006

HIGHLIGHT:

I.R.C. § 817 — Procedural Requirements Set Forth for Qualified Pension or Retirement Plans to Invest in Funds Meeting Diversification Requirements under the Look-Through Rule

In PLR 200607011 (Nov. 14, 2005), the IRS determined that the holding of beneficial interests in regulated investment companies (RICs) by qualified pension or retirement plans would not affect the application of the look-through rule in determining whether the diversification requirements of I.R.C. § 817(h) are met, provided the funds satisfy certain administrative and verification requirements (e.g., identifying the name, sponsor and administrator of the plan; detailing the plan's qualified status as a plan described under Rev. Rul. 94-62; the plan agreeing to notify the company if it loses qualified status and to redeem the plan's fund shares within 90 days; soliciting plans every three years for re-verification of qualified status and maintaining a list of non-responding plans; and other record-keeping and procedural requirements). See Company Issues.

LEGISLATION

In General — The 2006 Budget Reconciliation Process Continues

Although the President signed into law the Deficit Reduction Act of 2005 on February 8th (i.e., the spending portion of the fiscal year 2006 budget reconciliation process), the tax portion of the 2006 budget reconciliation process has only just gone into conference between the House and the Senate. 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. How the differences will be resolved still seems to be a mystery, but both sides seem to have hope that the House and Senate differences can be resolved before the Congressional recess planned for the last half of March.

Of interest to insurers, the Deficit Reduction Act of 2005 signed into law contains a long-term care insurance partnership provision that allows consumers who purchase long-term care insurance under the program and fully utilize their benefits prior to qualifying for Medicaid to protect personal assets equal to the long-term care benefits received on a dollar-for-dollar basis for purposes of determining Medicaid qualification. The provision, which was strongly supported by the life insurance industry, is designed to provide an incentive for consumers to purchase long-term care partnership insurance policies and stay off Medicaid.

POLICYHOLDER ISSUE

I.R.C. §§ 101 and 1001 — Exchange of Life Insurance Policies Between Grantor's Trusts Is Disregarded for Federal Tax Purposes

In PLR 200606027 (Nov. 9, 2005), the IRS ruled that a transaction exchanging life insurance policies between two grantor trusts owned by the same individual would be disregarded for federal income tax purposes and would not be subject to the transfer-for-value rule of I.R.C. § 101(a)(2). In the facts of the ruling, an individual created two grantor trusts: one for the benefit of his children and children of his spouse, and one for the benefit of his grandchildren and grandchildren of his spouse. Both trusts owned two life insurance policies: one on the life of the grantor, and one on the life of the grantor and his spouse. The grantor proposes to transfer the policies from one trust to the other, in exchange for the other two policies, valued at their interpolated terminal reserve value, as required by Treas. Reg. § 25.2512-6(a). Because the value of the policies from the first trust is greater than those held by the second trust, additional assets, or a promissory note equal to any deficiency plus any applicable federal interest rate, would also be transferred to the first trust with the policies. Citing Rev. Rul. 85-13, 1985-1 C.B. 184, the IRS states that a grantor is considered the owner of the trust's assets for federal income tax purposes when the grantor is treated as the owner of the entire trust, as was the case in point. A transaction cannot be recognized as a sale or exchange for federal income tax purposes if the same person is the owner of the assets (i.e., the grantor) both before and after the transaction. Therefore, the transaction in the ruling would be disregarded for federal income tax purposes and would not result in recognition of any gain or loss under I.R.C. § 1001. Additionally, the IRS concluded that the transaction would not be a transfer for a valuable consideration under I.R.C. § 101(a)(2) and the exclusion of gross income received under a life insurance contract would not be diminished for amounts received by the beneficiaries of any of the policies.

COMPANY ISSUES

1. I.R.C. § 267 — Appeals Court Affirms Use of Cash Method When Deducting Interest Payments to Foreign Related Party

In Square D Co. v. Commissioner, No. 04-4302 (7th Cir. Feb. 13, 2006), a United States Court of Appeals affirmed the Tax Court's decision that the cash method of accounting for interest owed to foreign related parties, required by Treas. Reg. § 1.267(a)-3, is reasonable. In the facts of the case, Square D, an accrual basis taxpayer, was acquired by a French corporation in a transaction in which the French corporation created an acquisition subsidiary through which it financed the purchase of stock of

Square D using loans obtained from the French corporation and its affiliates. After the acquisition, the subsidiary was merged into Square D, who subsequently paid off the loans and related interest. Under I.R.C. § 267(a)(2), when a taxpayer and a related party employ different systems of accounting, the taxpayer can claim deductions for certain types of payments made to the related party only in the taxable year in which income is recognized. For payments to foreign related parties, I.R.C. § 267(a)(3) provides that a taxpayer can claim deductions under regulations that apply the same matching principle. Treas. Reg. § 1.267(a)-3 was promulgated to govern when an amount paid to a related foreign party may be deducted and generally provides for the cash method of accounting when claiming deductions for payments to a related foreign party. On audit and in the Tax Court, Square D argued that it could deduct the interest as it was accrued because the regulation is based on a flawed interpretation of I.R.C. § 267 and therefore is invalid. The Tax Court upheld the validity of the regulation, and Square D appealed. The court of appeals affirmed, holding that although Treas. Reg. § 1.267(a)-3 does not employ the matching principle of I.R.C. § 267, the regulation is supported by the legislative history and is a reasonable interpretation of an ambiguous statute. Thus, Square D had to take deductions for payments to a foreign related party based on the cash method, rather than the accrual method.

2. IRC Sec. 446 — IRS Clarifies Guidance on Abusive NPCs

The IRS, in Notice 2006-16, 2006-9 I.R.B. 538, narrowed the scope of earlier guidance that had identified as listed transactions certain transactions involving the use of notional principal contracts (NPCs). In Notice 2002-35, 2002-1 C.B. 992, the IRS advised that transactions involving the use of an NPC to claim current deductions for periodic payments made by the taxpayer while disregarding the accrual of a right to receive offsetting payments in the future may be subject to penalties and tax shelter registration and list maintenance requirements. Notice 2006-16 narrows the scope of the previous guidance, clarifying that an NPC that requires a counterparty to make a contingent non-periodic payment is not substantially similar to the transaction in Notice 2002-35 if the taxpayer takes the contingent non-periodic payment into account over the life of the contract under a reasonable amortization method and properly accounts for the NPC under I.R.C. § 475 and Treas. Reg. §§ 1.446-4, 1.988-2(e) or 1.988-5(a). Transactions meeting these requirements will not be subject to tax shelter reporting requirements as of May 6, 2002. The Notice also provides a safe harbor for taxpayers that participated in listed transactions under Notice 2002-35 solely due to an interest in a pass-through entity. Effective February 13, 2006, such taxpayers are not required to file disclosure statements regarding the transactions, so long as they receive notice that the pass-through entity will comply with its disclosure requirements.

3. I.R.C. § 809 — Differential Earnings Rates Released by IRS

In Notice 2006-18, 2006-8 I.R.B. 502, the IRS sets forth the last tentative recomputed differential earnings rate of zero for 2004, for use by mutual life insurance companies in computing income tax liability. Although I.R.C. § 809 was repealed, it is still applicable for taxable year 2004.

4. I.R.C. § 817 — Procedural Requirements Set Forth for Qualified Pension or Retirement Plans to Invest in Funds Meeting Diversification Requirements under the Look-Through Rule

In PLR 200607011 (Nov. 14, 2005), the IRS determined that the holding of beneficial interests in regulated investment companies (RICs) by qualified pension or retirement plans would not affect the application of the look-through rule in determining whether the diversification requirements of I.R.C. § 817(h) are met, provided the funds satisfy certain administrative verification requirements. In the facts of the ruling, a life insurance company is the investment adviser to two RICs, each of which consists of a number of separate funds that are considered RICs under I.R.C. § 851. Aside from shares in the funds that are held by one governmental retirement plan, as described in I.R.C. § 414(d), all shares are held solely as underlying investments for variable contracts. The insurance company intends to allow trustees of qualified pension or retirement plans to acquire shares in the funds through an arrangement made within the meaning of Treas. Reg. § 1.817-5(f)(3)(iii). The IRS ruled that satisfaction of the requirements of Treas. Reg. § 1.817-5(f)(2)(I), allowing for the application of the look-through rule in determining whether the segregated asset accounts upon which variable products are based is adequately diversified, shall not be prevented by reason of beneficial interests in the fund being held by a plan, provided that a number of administrative and verification requirements (e.g., identifying the name, sponsor and administrator of the plan; detailing the plan's qualified status as a plan described under Rev. Rul. 94-62; the plan agreeing to notify the company if it loses qualified status and to redeem the plan's fund shares within 90 days; soliciting plans every three years for re-verification of qualified status and maintaining a list of non-responding plans; and other record-keeping and procedural requirements) are satisfied.

5. I.R.C. § 833 — BCBS Organization's Conversion to For-Profit Stock Corporation Is a Material Change

In TAM 200607020 (Oct. 27, 2005), the IRS determined that the conversion of a nonprofit Blue Cross and Blue Shield (BCBS) organization to a for-profit stock corporation constituted a material change in structure under I.R.C. § 833(c)(2)(C). The taxpayer was formed as a not-for-profit mutual BCBS organization. Both the taxpayer and its subsidiaries qualified as existing BCBS organizations before the taxpayer converted to a publicly-traded stock insurance company. In the year of the conversion, the taxpayer and its subsidiaries claimed tax benefits available to existing BCBS organizations, using either the special deduction provided in I.R.C. § 833(a)(2) or the fair market basis rule in section 1012(c)(3)(A)(ii) of the Tax Reform Act of 1986. The IRS reviewed the legislative history of I.R.C. § 833 and section 1012 of the 1986 Act, which provides there must be no material change in the operations of the organization and no material change in the structure of the organization for an organization to qualify as an existing BCBS organization. Whether there was a material change in the operations was not an issue in the TAM, but the IRS determined the conversion to a for-profit involved a number of changes in the structure of the organization, including changes in the articles of incorporation and, through the issuance of stock, significant changes in the fiduciary responsibility of the directors and the creation of rights and responsibilities to which the taxpayer was not subject to as a non-stock non-profit organization. The IRS determined such changes constituted a material change in the structure of the taxpayer, and the taxpayer did not qualify as an existing BCBS organization under I.R.C. § 833(c)(2) following its conversion. Because I.R.C. § 833(c)(2)(C) provides that an organization does not qualify as an existing BCBS organization if there is a material change before the close of the taxable

year, neither the taxpayer nor its subsidiaries qualified as existing BCBS organizations for the tax year in which the conversion occurred and the claimed tax benefits were not available to the taxpayer and its subsidiaries.

6. IRS Allows for Automatic Filing Extensions for Noncorporate Businesses

The IRS, in news release IR-2006-29 (Feb. 16, 2006), announced a simplified process for noncorporate business taxpayers, including partnerships and trusts, to file for an extension of time to file tax returns for 2005. All taxpayers that previously used Forms 8736, 2758 and 7004 now need to file only the revised Form 7004, Application for Automatic 6-Month Extension of Time to File Certain Business Income Tax, Information, and Other Returns, to receive an automatic extension. The news release follows in the footsteps of T.D. 9229, 2005-48 I.R.B. 1051, which provided that many taxpayers were eligible to request six-month automatic extensions without providing a signature or explanation. Forms 7004 are due by the tax return due date, and the IRS reminds taxpayers that they may be subject to late payment penalties and will owe interest on any taxes not paid by the return due date.

7. IRS Issues Proposed Regulations on Circular 230

The IRS and Treasury issued proposed regulations (REG-122380-02) to modify the rules governing practice before the IRS. Under the proposed regulations, Circular 230 would be modified to prohibit contingent fees for any matter before the IRS, including the preparation or filing of a tax return, amended tax return or claim for refund or credit. However, contingent fees may be charged for services in connection with IRS's examination of, or challenge to, an original return, as well as an amended return or claim for refund or credit filed prior to the taxpayer receiving notice of the examination of, or challenge to, the original tax return. The proposed regulations also provide additional guidance on disciplinary proceedings and would require written consent from each affected client in the case of conflicts of interest. Additionally, among other practice issues, the proposed revisions would modify the definition of practice, eligibility for enrollment to practice, and provisions regarding unenrolled practice. Standards for tax opinions were not addressed in the new proposed regulations. Comments on the proposed regulations and outlines for a June 21, 2006 public hearing are due by April 10, 2006.

8. IASB Announces Upcoming Discussion Paper on Insurance Contracts

As part of its high-priority project on insurance contracts, the International Accounting Standards Board (IASB) announced plans to issue a discussion paper by year-end that may provide "major changes to the insurance accounting framework." Of note, the IASB may break from more historical cost-based valuations by insurers and lean towards more use of "current value" models, which reflect the discounting of items such as loss reserves by property and casualty companies (which is not currently done in the United States) and the use of risk margins.

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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