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TAX ISSUES SUMMARY

March 29, 2006

HIGHLIGHTS:

I.R.C. §§ 404 and 832 — IRS Denies Use of Safe Harbor Method of Accounting for Premium Acquisition Expenses

The IRS, in TAM 200610016 (Nov. 21, 2005), concluded that an insurance company and its affiliated group of insurance companies cannot use the safe harbor method of accounting in Rev. Proc. 2002-46, 2002-2 C.B. 105, to avoid the I.R.C. § 404 deductions limitations on compensation allocable to a deferred compensation plan for its independent contractor agents. See Company Issues.

Recommendations Requested for the 2006-2007 Guidance Priority Plan

In Notice 2006-36, the Department of Treasury and the IRS invited public comments on recommendations for items that should be included in the 2006-2007 Guidance Priority List. For items to be considered for possible inclusion in the initial 2006-2007 Guidance Priority List, recommendations should be submitted by May 15, 2006. See Company Issues.

LEGISLATION

In General

Conferees for the 2006 tax budget reconciliation bill finally convened a couple of weeks ago, however little progress has been reported. The assumption is that negotiations are going on behind the scenes. The big unresolved issue continues to be what compromise will be reached on the AMT fix (in the Senate bill) vs. the extension of the special rates for dividends and capital gains. Likewise, the conference on the pension bill continues, with the continuing expectation that a conference agreement will be reached by mid-April. With the tax-writing committees still finishing up business from the 2005

session, and despite desires for the passage of “extender” provisions and technical corrections, the chance of new tax legislation in 2006 continues to carry a question mark.

POLICYHOLDER ISSUE

I.R.C. §§ 79, 83, and 402(a) — Plan’s Sale of Life Insurance Contract Not Affected by IRS Amendments

In Advisory Opinion 2006-03A (Mar. 28, 2006), the Department of Labor’s Employee Benefits Security Administration determined that the relief set forth in Prohibited Transaction Exemption (PTE) 92-6 is not affected by amendments to regulations under I.R.C. §§ 79, 83, and 402(a). See T.D. 9233 (166 DTR G-1, L-5, Aug. 29, 2005) (clarifying that life insurance contracts distributed from qualified retirement plans are required to be valued at fair market value). PTE 92-6 provides, in part, that certain restrictions of the Employee Retirement Income Security Act of 1974 (ERISA), as well as taxes imposed by I.R.C. § 4975 (a), (b), and (c)(1)(A)-(E), shall not apply to the sale of an individual life insurance or annuity contract by an employee benefit plan to a participant so long as certain conditions are met. Advisory Opinion 2006-03A considered the situation of an employee and his spouse wishing to jointly purchase a policy from a tax-qualified plan for its cash surrender value, the policy involved having been purchased solely with funds from the employee’s rollover account. The opinion concluded that the sale was allowable (i.e., not a prohibited transaction) because the following conditions would be met: (1) the participant is the insured under the contract; (2) that the contract would, but for the sale, be surrendered by the plan; and (3) that the amount received by the plan as consideration for the sale is at least equal to the amount necessary to put the plan in the same cash position as it would have been had it retained the contract, surrendered it, and made any distribution owing to the participant on his vested interest under the plan.

COMPANY ISSUES

1. I.R.C. §§ 351 and 453A — Interest Charges Eliminated in Sale of Notes from Parent Corporation to Subsidiary

The Court of Federal Claims, in Principal Life Insurance Co. v. United States, No. 02-1278 T (Mar. 17, 2006), held that the transfer of notes by a parent corporation to a wholly-owned subsidiary qualified as a sale that triggered installment sales gain, thereby eliminating any I.R.C. § 453A interest charges. In the facts of the case, real estate mortgage loans owned by two life insurance companies, Prudential Life Insurance Company and Principal Life Insurance Company, were sold to one another prior to 1995. The companies later sought to unravel the transaction, which would result in the generation of a deferred gain, subject to interest under I.R.C. § 453A, to be recognized by each company. Principal Life formed a wholly-owned subsidiary and, when it bought its notes back from Prudential, Principal Life simultaneously sold its installment notes to the subsidiary in an effort to reduce the interest charges. On its consolidated return, Principal Life reported the sale of the Prudential’s notes back to Prudential, and elected to report the related gain using the I.R.C. § 453A installment method, but did not show any interest on the deferred tax liability. To determine whether interest was owed on the transaction, the court examined what constitutes a transfer for purposes of I.R.C. § 351. The transaction

would be a sale if the notes transferred to the parent corporation by the subsidiary were debts, while the transaction would be an exchange if the parent corporation received equity. Because the transaction involved multiple parties and it was not designed solely to avoid taxes, the court concluded that the transaction was not an transfer but rather a sale and that the subsidiary owns to the notes. Accordingly, when the Principal Life sold the notes to the subsidiary, the sale triggered I.R.C. § 453B gain and eliminated the applicability of I.R.C. § 453A.

The court also considered whether the parent's payments to a state guaranty fund were taxes deductible under I.R.C. § 164. The court determined that the state assessments are not a tax, but instead nondeductible a regulatory fee.

2. I.R.C. §§ 404 and 832 — IRS Denies Use of Safe Harbor Method of Accounting for Premium Acquisition Expenses

The IRS, in TAM 200610016 (Nov. 21, 2005), concluded that an insurance company and its affiliated group of insurance companies cannot use the safe harbor method of accounting in Rev. Proc. 2002-46, 2002-2 C.B. 105, to avoid the I.R.C. § 404 deductions limitations on compensation allocable to a deferred compensation plan for its independent contractor agents. In the facts of the TAM, an insurance company and its affiliated companies sell property and casualty coverages through independent contractor agents. An agreement providing for the independent contractor status of the agents also provides for a deferred compensation arrangement under which the insurer pays agents additional amounts upon their retirement or termination, based on the agents' past business performance. Because the plan expenses seemed to meet the definition of premium acquisition expenses, the insurer filed an application for change in method of accounting to use the safe harbor method of accounting for premium acquisition expenses set forth in Rev. Proc. 2002-46, which would have treated the amounts as deductible premium acquisition expenses not limited by I.R.C. § 404. The IRS determined that, although the insurer's deferred compensation liabilities might meet the definition of premium acquisition expenses under Rev. Proc. 2002-46, the deduction limitations of I.R.C. § 404 must be met independent of that revenue procedure's safe harbor; that the safe harbor method of accounting therein does not override such limitations. Thus, the IRS determined that insurer cannot employ the Rev. Proc. 2002-46 safe harbor method of accounting for premium acquisition expenses that are part of a deferred compensation plan.

3. I.R.C. § 409A — IRS Provides Transition Relief for Some Nonqualified Deferred Compensation Plans

In Notice 2006-33, 2006-15 I.R.B. ___, the IRS provided transition relief to certain offshore trusts and deferred compensation plans in order to give them additional time to come into compliance with I.R.C. § 409A. This additional transition time was part of corrections made to I.R.C. § 409A by the Gulf Opportunity Zone Act of 2005 (Pub. L. No. 109-135), enacted December 21, 2005. The tax imposed on income included under I.R.C. § 409A(b)(1) (due to use of an offshore trust or similar arrangement) or I.R.C. § 409A(b)(2) (due to a restriction on assets in connection with a change in the financial health of the service recipient) is increased by the sum of the amount equal to 20% of the amount required to be included in income, plus an interest charge based on the underpayment interest rate plus 1% determined on the underpayments of tax that would have occurred if the affected deferred amounts had been includible in income for the taxable year when first deferred. The guidance addresses the definition of a

nonqualified deferred compensation plan, and notes that until further guidance is issued, taxpayers should rely on the definition provided in Notice 2005-1, 2005-2 I.R.B. 274 and in the proposed regulations (REG-158080-04) for I.R.C. § 409A(b) purposes.

4. I.R.C. § 409A — Increased Scrutiny for Deferred Compensation Issues for LMSB Taxpayers

On March 24, 2006, at the annual Capital Summit of the American Payroll Association, the director of field specialists from the IRS Large and Midsize Business Division (LMSB) said that the IRS will be examining 2005 corporate tax returns closely for nonqualified deferred compensation issues. LMSB's executive compensation compliance group will be looking at returns of large companies and their highly paid executives to assess the compliance risk posed by the new rules under I.R.C. § 409A and to determine compliance with income and employment tax obligations. See Notice 2005-1, 2005-3 I.R.B. 274 (interim guidance on the reporting and wage withholding requirements under I.R.C. § 409A). By spotting trends in 2005 returns, the compliance teams will identify issues on which agents should be focusing. In this context, the IRS already has spotted disguised parachute payments, charitable contributions, and high-level administrative support being included in severance packages.

5. I.R.C. § 412(I) — Court Refuses to Dismiss a Suit for Damages Relating to an Insurance Policy Tax Shelter Case

In Kennard v. Indianapolis Life Insurance Co., No. 3:05-CV-1247-G (N.D. Tex. Mar. 9, 2006), a United States District Court denied motions to dismiss a suit seeking damages for costs incurred in the purchase of multiple life insurance policies in support of an I.R.C. § 412(I) defined benefit plan that was subsequently identified as a listed transaction. In the facts of the case, plaintiff Charles Kennard established a defined benefit plan for his professional association that was funded entirely by life insurance policies and was purported to be in compliance with I.R.C. § 412(I), thus providing significant tax benefits. The IRS subsequently identified such a life insurance policy arrangement as a listed transaction, indicating that such policy arrangements would not qualify as I.R.C. § 412(I) plans and that related tax deductions would not be permitted. Additionally, it was determined that the policies involved in Kennard's plan had not been approved by the state department of insurance. Kennard filed suit against the issuer of the policies, Indianapolis Life Insurance Company, and against those who had acted as agents for Indianapolis Life, for rescission of the policies and damages arising from unfair trade practices. Despite arguments that the claims should be dismissed because Kennard could not show damages arising from non-approval of the policies and had not yet suffered denial of the deductions for the plan, the court allowed Kennard to proceed because the life insurance policy arrangement had already triggered an IRS audit, which had caused Kennard to incur substantial attorney fees.

6. I.R.C. § 501(c)(15) — IRS Denies Tax-Exempt Status for Insurance Entity

In PLR 200603030 (Oct. 25, 2005), the IRS concludes that an organization does not qualify for I.R.C. § 501(c)(15) tax-exempt status because the IRS found that the organization did not issue a sufficient number of insurance policies and those it did issue had little or no risk-shifting or risk distribution. In addition, the IRS noted that the organization's predominant activity was investing and its

primary source of income came from investments. Because the organization did not operate as an insurance company for federal income tax purposes, it could not qualify for exemption under I.R.C. § 501(c)(15).

7. Court of Appeals Does Not Enforce Third-Party Summons, Citing Failure of Relevance Test and IRS Possession of Requested Documents

The Sixth Circuit Court of Appeals declined to enforce a third-party summons issued to a life insurance company in connection with the IRS's investigation of a corporation's use of life insurance products because it found that the IRS had many of the documents sought by the summons in its possession and had not demonstrated relevance for the majority of the requested documents. United States v. Monumental Life Ins. Co., No. 05-5080 (6th Cir. Mar. 3, 2006). In the facts of the case, the IRS served a third-party summons on Monumental Life, in connection with its investigation into deductions taken by Johnson Systems Inc. for employer contributions to an employee welfare benefit plan and used to purchase three types of group life insurance issued by Monumental Life. The IRS requested 172 categories of documents from Monumental Life; some of the documents requested related directly to Johnson Systems as the employer, while others related broadly to other products issued by Monumental Life. After an initial motion to quash the summons was denied, the insurance company partially complied with the summons, and expressed willingness to continue production if a protective order to keep proprietary information confidential were issued. The IRS was not willing to do this, and the issue was taken to a magistrate judge. Despite the magistrate's recommendation to deny enforcement in full, the district court entered an order enforcing the summons in full, which the insurance company appealed.

For enforcement to be granted, the government must make a prima facie showing for enforcement, the elements of which can then be disproved by the opposing party. The court of appeals found that, although the prima facie case had been established by the IRS, two elements were effectively disputed by Monumental Life: (1) that many of the documents sought by the summons were already in the possession of the IRS; and (2) that some of the requested documents appear to be far removed from the investigation of the employer's tax liability. Rather than remanding the case for continued dispute at the trial court level, the court of appeals denied enforcement of the summons in full, leaving the option open to the IRS of drafting a more narrowly tailored summons to obtain relevant documents from the insurance company.

8. Recommendations Requested for the 2006-2007 Guidance Priority Plan

In Notice 2006-36, the Department of Treasury and the IRS invited public comments on recommendations for items that should be included in the 2006-2007 Guidance Priority List. In reviewing recommendations and selecting projects for inclusion, consideration will be given to: (1) whether the guidance would resolve significant issues relevant to many taxpayers; (2) whether the guidance would promote sound tax administration; (3) whether the guidance can be drafted in a manner that will allow taxpayers to easily understand and apply the guidance; (4) whether the IRS can administer the guidance on a uniform basis; and (5) whether the guidance would reduce controversy and lessen the burden on taxpayers and the IRS. For items to be considered for possible inclusion in the initial 2006-2007 Guidance Priority List, recommendations should be submitted by May 15, 2006.

Also, on March 6th, the IRS and Treasury released the third quarterly update of the 2005-2006 guidance priority plan. In addition to listing projects that have been completed, the update contains 58 items recently added. Of note, guidance is expected on whether a split-dollar arrangement will continue to be grandfathered under the current rules while a plan is being revised to comply with I.R.C. § 409A.

9. New York Insurance Department Increases Life Insurance Reserve Requirements for Life Insurance Policies with Secondary Guarantees

The New York State Insurance Department adopted an emergency regulation amendment, which increases reserve requirements for eight classes of life insurance policy guarantees, in an effort to prevent insurers from getting around existing reserve requirements. The amendment to Regulation 147 (11 NYCRR 98.1 through 98.10) lists the following features as those that may increase reserve requirements: limits on the insurer's ability to increase premiums; refund options; agreements with a second insurer that will somehow limit premium increases; designs making net costs to the policyholder lower than the gross premium; re-entry provisions that might permit the holder of a term life policy to buy an additional term of coverage with little underwriting at specified rates; cumulative catch-up provisions sold with universal life policies; provisions that keep universal life policies from lapsing as long as premiums are paid; and provisions that let net reinsurance payments remain unchanged after a change in premium is made. The amendment contains a long explanation of how insurers should calculate universal life secondary guarantee reserves, sets mortality and reserve standards for credit life insurance policies and explains how insurers should reserve for long-term care acceleration benefits attached to life insurance policies. The amendment, which is considered to be consistent with National Association of Insurance Commissioners (NAIC) standards, applies to financial statements filed on or after December 31, 2004.

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For comments or questions, or if you would like to receive the Tax Issues Summary via electronic mail, please contact Katherine L. Berland at (202) 434-9169 or kberland@scribnerhall.com Scribner, Hall & Thompson, LLP, website: www.scribnerhall.com