

# 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. JONES  
SAMUEL A. MITCHELL  
LYNLEE C. BAKER-GARBETT

FRED C. SCRIBNER, JR. (1908-1994)  
LEONARD W. HALL (1900-1979)

## TAX ISSUES SUMMARY

June 28, 2006

### **HIGHLIGHTS:**

#### **House Passes an Estate Tax Compromise Bill**

After the Senate failed to bring full repeal of the estate tax to a vote, House Ways and Means Chairman Thomas succeeded in a matter of a couple of weeks to put together an estate tax compromise and bring it to the floor of the House for a vote. On Thursday, June 22, 2006, the House of Representatives passed Thomas' Permanent Estate Tax Relief Act of 2006 (H.R. 5638) with a vote of 269 to 156. Although there had been plans to bring H.R. 5638 to a vote in the Senate before the July 4<sup>th</sup> recess, the Senate vote is now expected to take place after that recess. See Legislation.

#### **I.R.C. § 815 — Elective PSA Transfers Not Likely to Be Considered Distributions**

At the Federal Bar Association Insurance Tax Conference on June 2, 2006, an IRS official said that elective policyholder surplus account (PSA) transfers under I.R.C. § 815(f) likely would not be considered taxable distributions under the tax waiver provision in I.R.C. § 815(g) (adopted by the American Jobs Creation Act of 2004, Pub. L. 108-357). See Company Issues.

## LEGISLATION

### **House Passes an Estate Tax Compromise Bill**

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269 to 156. Beginning in 2010, this bill would set the personal lifetime exemption at \$5,000,000 and allow unused exemption by a spouse to carry over to the surviving spouse; index the exemptions to inflation; apply the capital gains tax rate to estates up to \$25,000,000; apply twice the capital gains tax rate to estates over \$25 million; reunify the estate and gift and generation skipping tax regimes; and create a 60 percent deduction for qualified timber capital gains from the date of enactment through 2008 (rumored to have been inserted to “buy” certain Senate votes). Although there had been plans to bring H.R. 5638 to a vote in the Senate before the July 4<sup>th</sup> recess, the Senate vote is now expected to take place after that recess.

Likewise, after predictions of progress on pension reform being made, reporting the bill out of conference for a vote before the July 4<sup>th</sup> recess is not likely to happen, either.

## **POLICYHOLDER ISSUES**

### **1. I.R.C. §§ 72 and 1035 — Rollover or Exchange Not Allowed for Distributed Annuity**

The IRS, in PLR 200622020 (June 6, 2006), ruled that an individual taxpayer may not roll over or exchange an annuity held in a trust for the individual when the full amount of the annuity has already been distributed to the trust. I.R.C. § 72 prescribes the tax treatment of amounts received under an annuity contract. I.R.C. § 1035(a)(3) provides that no gain or loss is recognized on the exchange of an annuity contract for another annuity contract, provided that the same person is the obligee under the contract received in exchange as under the original contract. The taxpayer argued that she should be allowed to roll over the proceeds of an annuity that was held in trust into an annuity in her name. She further argued that she should be allowed to use the proceeds she received under the annuity to purchase a second annuity contract, and treat the transaction as a tax-free exchange. The IRS indicated that the annuity held in trust was a nonqualified annuity and thus provisions allowing the rollover of a qualified annuity for another qualified annuity did not apply. Also, I.R.C. § 1035 does not allow the proceeds distributed by one annuity contract to be used to purchase an additional contract. Because the annuity proceeds already had been distributed to the trust, there was no longer an annuity that could be exchanged.

### **2. I.R.C. § 104 — Damages Paid for Defamation Claim Are Taxable as Gross Income**

In Polone v. Commissioner, No. 04-72672 (June 5, 2006), the Ninth Circuit Court of Appeals affirmed a Tax Court ruling that damages received on a defamation claim after the effective date of an amendment to I.R.C. § 104(a)(2) that excluded such damages from amounts received on account of “personal injuries or sickness” are properly included in the plaintiff’s gross income under the plain meaning of I.R.C. § 104(a)(2), as amended in 1996. Whereas I.R.C. § 104(a)(2) had excluded all damages received on account of “personal injuries or sickness,” which had been interpreted to include damages from settlements of defamation claims, the section was amended in August 1996 to limit the scope to damages from “personal physical injuries or sickness” (emphasis added). In the facts of the case, the plaintiff settled a defamation and wrongful termination claim against his former employer, the settlement being finalized in May 1996, with damages being paid to the plaintiff in four equal installments, in May 1996, November 1996, May 1997, and November 1998. The amendment specified

that it would not apply to any “amount[s] received under a written binding agreement, court decree, or mediation award in effect on (or issued before) September 13, 1995,” but was otherwise effective for any damages received after August 20, 1996. The court held that any payments received after the effective date of the amendment are includible in the plaintiff’s gross income, as the settlement agreement took place after the exception date listed in the amendment. Thus, only the first of the four installment payments, which was made three months prior to the amendment’s effective date, could be excluded from plaintiff’s gross income under the pre-amendment I.R.C. § 104.

### **3. I.R.C. § 162 — Sole Proprietors May Deduct Health Insurance Costs**

In CCA 200623001 (Mar. 3, 2006), the IRS concluded that a sole proprietor may deduct insurance costs for the sole proprietor and his or her spouse and dependents pursuant to I.R.C. § 162(l), provided that the insurance policy is in the name of the individual rather than in the name of the sole proprietor’s trade or business. Under I.R.C. § 162(l)(4), the deduction shall not be taken into account in determining an individual’s net earning from self-employment for purposes of Chapter 2. Accordingly, the deduction under I.R.C. § 162(l) must be claimed as an adjustment to gross income on the face of Form 1040. The advice specifies that a self-employed individual may not deduct the costs of health insurance on Schedule C.

## **COMPANY ISSUES**

### **1. I.R.C. § 815 — Elective PSA Transfers Not Likely to Be Considered Distributions**

At the Federal Bar Association Insurance Tax Conference on June 2, 2006, John Prisco, a technical adviser in the life insurance area of LMSB, said that policyholder surplus account (PSA) transfers likely would not be considered taxable distributions under the tax waiver provision in I.R.C. § 815(g) (adopted by the American Jobs Creation Act of 2004, Pub. L. 108-357). Prisco said that the question had been raised with IRS and Treasury personnel soon after 2004 as to whether a grandfathered prior law provision under I.R.C. § 815(f), which allows a company to elect to transfer amounts from its PSA to its shareholder surplus account if it pays the tax applicable to amount of the transfer, would be considered to result in a distribution for purposes of the tax waiver. Unless the IRS and Treasury issues guidance to the contrary, Prisco predicted that IRS examiners would take the position that only actual distributions qualify for the tax waiver provision.

### **2. I.R.C. § 1502 — IRS Issues Guidance that Eases Reporting Rules for Consolidated Groups**

On May 26, 2006, the IRS released a guidance package that includes Rev. Proc. 2006-21, proposed regulations REG-134317-05, and final and temporary rules T.D. 9264. The changes, which became effective May 30, 2006, ease certain reporting requirements to facilitate electronic filing of returns by large corporations and shareholders. One example of eased reporting is found in T.D. 9264, where the IRS said it will require information only from “significant shareholders” in certain distributions or exchanges, such as stock and securities transfers under I.R.C. § 351. Also, Rev. Proc. 2006-21 eliminates the requirement that a parent of a consolidated group sign a statement in order to obtain a consent or waiver of reporting requirements, replacing the signature requirement with a

requirement for a simplified statement of continued compliance. Though Rev. Proc. 2006-21 has an effective date of May 26, 2006, the IRS said that taxpayers may rely on the guidance for prior tax years.

**3. I.R.C. § 6038 — IRS Implements Reporting Requirements for Foreign-Owned Company Transactions**

The IRS issued final and temporary regulations (T.D. 9268) and proposed regulations (REG-109512-05) on June 20, 2006, that put in place new reporting requirements and penalties for information returns filed by foreign corporations and foreign-owned domestic corporations. The new rules expand, in some cases, the information taxpayers must report for related-party transactions by foreign and foreign-owned companies under I.R.C. §§ 6038 and 6038A. An example of an expansion under the new rules is that taxpayers are now required to report premiums paid for insurance and reinsurance, rather than only premiums received. According to the preamble to the new rules, the purpose of I.R.C. § 6038 is to treat sales and purchases, and premiums paid and received, consistently.

**4. I.R.C. § 6041 — No Breach of Settlement Agreement by Insurer Reporting Proceeds**

In Ward v. American Family Life Assurance Company of Columbus (AFLAC), No. 2:05-2120-PMD (May 16, 2006), the District of South Carolina District Court granted the defendant's motion for summary judgment, and dismissed the plaintiff's suit against the insurer to compel the insurer to amend its Form 1099-MISC to reflect that no part of the proceeds of the settlement was taxable income. The insurer previously filed its Form 1099-MISC reporting \$85,600,000 of the settlement as "other income." The proceeds were in settlement of plaintiff's suit for disability benefits from the insurer under an accidental death and dismemberment policy. By its terms, the settlement agreement did not expressly forbid filing of the Form 1099-MISC. However, the settlement agreement did provide that "all sums paid in accordance with the agreement are for compensation for physical injuries and damages and/or emotional injuries and damages and are intended to compensate the Plaintiff solely for his losses suffered in connection with those injuries and damages." Ultimately, the court was not willing to order the defendant to file an amended Form 1099-MISC, and found that the defendant's decision to report the amounts, entirely reasonable.

**5. Court Refuses to Dismiss Equitable Fraud Claim in COLI Plan Suit**

In Wal-Mart Stores Inc. v. AIG Life Insurance Co., No. 172 (June 6, 2006), the Delaware Supreme Court denied the defendant's motion to dismiss the alleged breach of fiduciary duty case in its entirety, and instead affirmed in part, reversed in part, and remanded the case for further consideration. Wal-Mart Stores Inc. brought action against several life insurance companies and brokers, alleging that the defendants breached their fiduciary duty in advising Wal-Mart to purchase corporate-owned life insurance (COLI) policies, whose substantial tax benefits were later disallowed by the IRS. The court ruled that Wal-Mart failed to state a claim for commercial frustration, and that it had assumed the risk that the expected tax deductions would be disallowed on the basis of Wal-Mart not having an insurable interest in its employees. The court further ruled that the relationship between Wal-Mart and the broker defendants was a typical arm's-length business relationship and, as such, is not fiduciary in character. Wal-Mart also alleged that the defendants misrepresented the viability of the COLI plans by failing to inform them that the plans deviated from industry standards, and that such deviations could lead to

disapproval of the plans. The court did not rule on this issue, instead remanding to the Court of Chancery to determine if this claim of equitable fraud should be transferred to the Superior Court.

#### **6. FASB Seeks Comment on Bifurcation Approach for Insurance Accounting; Potential Guidance on Accounting for Split-Dollar Life Insurance**

As part of its initiative to improve financial reporting for insurance accounting, on May 26, 2006, the Financial Accounting Standards Board (FASB) asked for comments by August 24<sup>th</sup> on the potential bifurcation of insurance and reinsurance contracts. Under the bifurcation approach, components of a specified insurance or reinsurance contract would be split into two parts: a financial instrument, which would be accounted for as a deposit, and an insurance contract, which would be accounted for under traditional insurance accounting. The FASB is specifically seeking comments on the definitions of “insurance contract” and “insurance risk;” whether insurance and reinsurance contracts should be bifurcated into insurance and deposit components; if so, which insurance and reinsurance contracts would be bifurcated; and, if so, how insurance and reinsurance contracts would be bifurcated. The FASB said that, in December, it would seek comments on whether a bifurcation proposal should be developed for inclusion in an exposure draft on risk transfer.

On June 15, 2006, the FASB Emerging Issues Task Force reached an agreement to float tentative guidance which would require an employer to recognize a liability in accounting for deferred compensation and post-retirement benefits through split-dollar life insurance arrangements.

#### **7. NAIC Representatives Meet with Treasury Officials**

While the National Association of Insurance Commissioners (NAIC) held its conference in Washington, DC, earlier this month, the Chairman of the NAIC Tax Policy Task Force, John Oxendine (Georgia Insurance Commissioner) reported that he and a NAIC Washington staff person had met with Treasury officials. According to Oxendine, Treasury officials seemed to be more open to discussion of insurance tax issues than when they met with Task Force members last year. As part of some general discussions concerning tax reform and the use of life insurance as a savings vehicle, Oxendine reported that Treasury officials asked if life insurers were being given a subsidy in the tax code and whether that should be continued. Oxendine reported that he told the Treasury officials that no subsidy exists and that current treatment should continue. Oxendine also reported that NAIC representatives asked about ways for employers to pass money tax-free to employees so that employees could use employers’ money to buy their own health insurance; Treasury officials apparently disagreed with Oxendine over whether such an arrangement would amount to a “double tax break.” Oxendine said that the NAIC hopes to meet three more times with Treasury after a new Treasury secretary is in place, to discuss life, health and property/casualty issues.

At its conference in Washington, the NAIC also authorized a new working group that will examine the issue of principles-based reserving. The working group was formed even as a number of American Academy of Actuaries’ working group advance toward completion of their work on principles-based reserving, including completion of new mortality tables by year-end 2006. Recognizing that principles-based reserving is a high priority for many life insurers because it will free up needed surplus

from unnecessary reserves, the ACLI has proposed an interim solution, which the NAIC could adopt at its fall meeting to get a framework of principles-based reserving in place by spring of 2007, allowing time for the more long-term project to be completed.

***IRS Circular 230 Disclosure:***

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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](mailto:kberland@scribnerhall.com) Scribner, Hall & Thompson, LLP, website: [www.scribnerhall.com](http://www.scribnerhall.com)**