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## TAX ISSUES SUMMARY

August 31, 2006

### ***HIGHLIGHTS:***

#### **Pension Protection Act of 2006 Enacted**

President Bush signed the Pension Protection Act of 2006 (“PPA”) on August 17, 2006, making permanent the higher contribution limits for IRAs and 401(k) plans adopted in 2001, allowing long-term care insurance to be combined with annuity contracts beginning in 2010, and restricting an employers’ tax benefit from company-owned life insurance (“COLI”) unless certain notice and consent, and insurable interest requirements are met. The new COLI provisions are effective generally for contracts issued after August 17, 2006. See Legislation.

#### **IRS and Treasury Release 2006-2007 Priority Guidance Plan**

On August 15, 2006, the IRS and Treasury jointly released the 2006-2007 Priority Guidance Plan, setting forth the tax-related guidance project that will be their focus for the next twelve months. The four projects listed for “Insurance Companies and Products” remain the same as in last year’s plan: (1) Guidance on the taxation of certain annuity contracts under I.R.C. § 72; (2) Guidance on the qualification of certain arrangements as insurance; (3) Guidance on the taxation of variable contracts as described in I.R.C. § 817(d); and (4) Final regulations under I.R.C. § 7702 regarding the attained age of the insured for purposes of testing the qualification of a contract as a life insurance contract (proposed regulations were published on May 24, 2005). See Company Issues.

## LEGISLATION

### **In General; Pension Protection Act of 2006 Enacted**

On August 3, 2006, following the House action of the prior week, the Senate passed the pension bill; however, the Senate failed to pass a second package that would have permanently reformed the estate tax, extended several popular tax relief provisions (e.g., two-year extensions of the state and local sales tax deduction and the research credit), and increased the minimum wage. Though some believe that more tax legislation is unlikely in the short time left in 2006, others believe that the extender package may well find its way on an omnibus appropriations bill before the year is out.

President Bush signed the Pension Protection Act of 2006 (“PPA”) on August 17. The PPA made permanent the higher contribution limits for IRAs and 401(k) plans adopted in 2001. Beginning in 2010, long-term care insurance can be combined with annuity contracts; the PPA also clarified that the cash value of a life insurance policy can be used to fund a long-term care insurance rider without being taxed. The PPA amended I.R.C. § 409A to restrict funding of non-qualified deferred compensation arrangements or rabbi trusts for highly compensated employees still further. Likewise, it restricted an employers’ tax benefit from company-owned life insurance (“COLI”) unless certain notice and consent, and insurable interest requirements are met, as well as annual reporting and record-keeping requirements. The insurance industry has characterized these changes as a codification of the current “best practices” of the industry. The new COLI provisions are effective generally for contracts issued after August 17, 2006.

Congress is expected back in session the first week of September, and is expected to turn its attention to appropriations before adjourning for the mid-term elections. Depending on the outcome of the mid-term elections, some expect the Congress to reconvene for a lame duck session in December.

## POLICYHOLDER ISSUES

### **1. I.R.C. § 72(t) — Retirement Account Distributions Not Subject Considered Substantially Equal Periodic Payments**

In PLR 200631025 (May 12, 2006), the IRS ruled that distributions from an individual retirement account (IRA) that failed to comply with the recipient’s selected distribution method do not constitute modification of series of substantially equal periodic payments under I.R.C. § 72(t)(1). The IRS found that the recipient had no reason to believe that the minimum distributions would not be based on the method he selected, and that the error was due to improper paperwork filing by the recipient’s investment advisor. Because of the error, the recipient received more from his IRA than should have been distributed. The IRS ruled that because the recipient did not intend to change the selected distribution method for a series of substantially equal periodic payments, the additional amount distributed will not be subject to the ten percent additional tax that normally would apply to such distributions.

**2. I.R.C. § 72(u) — Annuity Held by Trust Qualifies as Though Held by a Natural Person**

In PLR 200626034 (Mar. 22, 2006), the IRS ruled that an annuity which was owned by a trust for natural person beneficiaries would be treated as being held by a natural person for purposes of I.R.C. § 72(u)(1) and the contract would be treated as an annuity contract for federal income tax purposes. In its determination, the IRS looked to the legislative history of I.R.C. § 72(u) which provides that an annuity contract owned by an entity that is not a natural person is treated as owned by a natural person if the legal owner is merely a nominal owner and the beneficial owner is a natural person. The IRS concluded that the ownership interest of the trust was nominal as compared with the interests of the trust beneficiaries, all of whom were natural persons and should be considered the beneficial owners of the annuity in question.

**3. I.R.C. § 104(a)(2) — Compensatory Damages Received for Nonphysical Injury Held Not Taxable**

In Murphy v. Internal Revenue Service, et al., No. 05-5139 (D.C. Cir. Aug. 22, 2006), the D.C. Circuit ruled that I.R.C. § 104(a)(2) violates the 16<sup>th</sup> Amendment (the amendment that authorizes income taxes) to the U.S. Constitution insofar as it attempts to tax compensatory damages for non-physical injury as income; such amount are not income under the 16<sup>th</sup> Amendment if they are unrelated to lost wages or earnings. Specifically, the D.C. Circuit concluded that damages for emotional distress, mental anguish and loss of reputation are recoveries of “human capital” and not “accessions to wealth.” Because taxpayers have no basis in human capital and recognize no income in gaining emotional strength or reputation, an award for damages to these items does not qualify as income under the 16<sup>th</sup> Amendment.

**4. I.R.C. §§ 104(a)(3) and 105(a) — Critical Illness Benefits Excluded from Gross Income**

In PLR 200627014 (Mar. 6, 2006), the IRS ruled that benefits paid under a life insurance contract’s critical illness rider qualify for exclusion from gross income for the amounts attributable to the employee’s after-tax contributions under I.R.C. § 104(a)(3). However, the amounts attributable to the employer’s contributions that were not includable in the employee’s income would be considered part of the employee’s gross income under I.R.C. § 105(a).

**5. I.R.C. §§ 105 and 213 — Medical Reimbursements Paid to Beneficiary Not Excludible from Income**

In Rev. Rul. 2006-36, 2006-36 I.R.B. \_\_\_\_ (Aug. 14, 2006), the IRS ruled that employee reimbursements that can be paid to a beneficiary as medical benefits deductible under I.R.C. § 213(d) cannot be excluded from income tax under I.R.C. § 105(b). The situation the ruling addresses is one in which an employer sponsors a reimbursement plan to reimburse employees for substantiated medical expenses. If the employee dies, the plan would also reimburse surviving dependents. Upon the death of all dependents, or if the employee were to die without any dependents, any unused reimbursement amount could be paid as medical benefits to a beneficiary designated by the employee. The IRS ruled that the designated beneficiary would not be able to exclude those amounts paid from income. The IRS reasoned that, because I.R.C. § 105(b) provides that cash or any other benefit under a health

reimbursement arrangement other than the reimbursement of medical care expenses do not qualify for exclusion, and because the payments made to beneficiaries do not offset the employees' (or dependents') direct medical expenses, any amounts paid to the beneficiary do not qualify for exclusion under this section of the code.

#### **6. I.R.C. § 264 — Deduction Disallowance of Insurance Contracts**

In PLR 200627021 (July 7, 2006), the IRS ruled that the interest expense deduction disallowance under I.R.C. § 264(f) would be allocable to the unborrowed cash value of a life insurance contract received by an employer-taxpayer in an exchange for a life insurance contract on the same insured if the insured were no longer an employee when the new contract is issued. The ruling letter explains that the taxpayer had purchased a life insurance contract on an employee and intends to exchange the contract for another contract on the same person, but the person is no longer an employee. The fact that the contract will be issued by a new company and will no longer insure an employee means that the new contract is materially different from the original contract; the new contract cannot be said to be the same contract as that originally issued. Thus, the IRS ruled that under I.R.C. § 264(f), although the deduction disallowance of the portion of the interest expense that is allocable to unborrowed policy cash value did not apply to the original contract because at the time the insured was an employee, the new contract, which will not cover the employee, will be subject to the I.R.C. § 264(f) interest expense deduction disallowance.

#### **7. I.R.C. § 403(b) — Effective Date for Proposed Regulations Postponed**

The IRS has announced that the general effective date for the proposed regulations on I.R.C. § 403(b) arrangements and related controlled group rules under I.R.C. § 414(c) will be extended to allow a reasonable period before the regulations go into effect. The final regulations will not be effective before January 1, 2008.

#### **8. I.R.C. § 4980G — Final Rule on Excise Tax for Employer HSA Contributions**

The IRS published final regulations (T.D. 9277) on July 31, 2006, regarding the imposition of an excise tax on an employer that does not make the correct contributions to employees' health savings accounts ("HSA"s). The regulations provide that, if an employer makes contributions to any employee's HSA, it must make comparable contributions to the HSAs of all comparable participating employees. Failure to do so subjects the employer to an excise tax equal to 35 percent of the aggregate amount contributed by the employer to the HSAs of its employees during that calendar year. However, the regulations "disregard" collectively bargained employees for purposes of the relevant code section. In addition, the regulations specify employer contribution levels for various combinations of individuals and individual-plus-dependents categories. The regulations also provide guidance on how employer HSA contributions are made through a "cafeteria plan" allowed by I.R.C. § 125. The final regulations, though effective July 31, 2006, will not be applicable until July 31, 2007, in order to give employers time to implement necessary changes to ensure compliance with the new rules.

## COMPANY ISSUES

### 1. **I.R.C. § 263 — Proposed Regulations on Capitalization of Tangible Assets Defer Decision on the *de Minimis* Rule**

The IRS has released proposed regulations (REG 168745-03) under I.R.C. § 263(a) that clarify and expand current regulations regarding amounts paid to acquire, produce or improve tangible property. While the proposed regulations provide a number of bright lines and safe harbors for application of the twelve-month rule and address the treatment of repair and improvement expenses and other items such as unit of property rules, they do not include a *de minimis* figure for acquisition costs; instead the preamble solicits comments on whether to include a *de minimis* rule in the final regulations. Generally, informal agreements between taxpayers and IRS agents that make acquisition expenditures in amounts below a certain threshold “off-limits” for examination collectively have been viewed as providing a *de minimis* rule. The proposed regulations’ preamble makes clear that the IRS does not intend the omission of a *de minimis* rule in the proposed regulations to disrupt these current informal arrangements. The IRS apparently considered a *de minimis* rule that would set certain threshold amounts that would key off of a taxpayer’s written policies for expensing amounts paid for tangible property costing less than a certain dollar amount on its Applicable Financial Statement (“AFS”). Taxpayers without an AFS would have been subject to different, lower threshold amounts. Comments on the proposed regulations are due November 20, 2006, and a public hearing is scheduled for December 19, 2006.

### 2. **I.R.C. § 809 — IRS Determines Recomputed Differential Earnings Rate for 2004**

In Rev. Rul. 2006-45, 2006-37 I.R.B. \_\_\_\_ (Aug. 22, 2006), the IRS sets forth the final determination of the “recomputed differential earnings rate” for 2004. I.R.C. § 809 provides that “the differential earnings rate shall be treated as zero for purposes of computing both the differential earnings amount and the recomputed differential earnings amount for a mutual life insurance company’s taxable years beginning in 2001, 2002, or 2003”. Because this section of the code was repealed in 2004 for taxable years beginning after December 31, 2004, the IRS is required to determine a differential earnings rate for 2004 and a recomputed differential earnings rate for 2004. The rate for differential earnings for the year 2004 was zero.

### 3. **I.R.C. § 831 — IRS Disallows Contracts Because They Do Not Transfer Risk**

In CCAs 200629028 and 200629029 (Apr. 14, 2006), the IRS stated its position that contracts proposed to be issued by a wholly-owned subsidiary of a nuclear power plant licensee would not constitute insurance for federal income tax purposes. Federal law requires that all nuclear power plants be subject to decommissioning when necessary, and in any event will be decommissioned within 60 years of beginning operations. The proposed contracts would indemnify a nuclear power plant licensee (the contract holder) for a fixed percentage of the costs associated with decommissioning a plant, irrespective of the reason the plant is decommissioned. The IRS reasons that, because all plants will eventually be subject to decommissioning, there would be no transfer of insurance risk. Accordingly, the contracts would not be insurance for federal income tax purposes.

**4. I.R.C. § 831 — Express Limited Warranty Does Not Qualify as Insurance**

In CCA 200628018 (Feb. 13, 2006), the IRS notified the IRS field offices that it would have ruled that a manufacturer's express limited warranty to consumers that "runs" with the product for a limited period of time did not constitute insurance for federal income tax purposes. The IRS determined that such an express limited warranties were not insurable risks because they were inseparable from the merchandise produced and sold, rather than a stand-alone insurance product. As such, it merely represents a business risk to the taxpayer rather than an insurable risk for purposes of federal income tax. This conclusion would not be changed by the fact that the manufacturer proposed to have its insurance subsidiary, which sells stand-alone extended warranties, indemnify the express limited warranties.

**5. I.R.C. § 831 — Certain Vehicle Loss and Theft Protection Plans Are Considered Insurance**

In PLR 200628004 (Apr. 10, 2006), the IRS ruled that a corporation that develops, markets, and administers vehicle service protection plans is an insurance company. The corporate taxpayer, through unrelated agents and independent agents, offers both a total loss protection plan and vehicle theft plans to vehicle owners. The plans provide for customer reimbursement in the event of a covered loss. The IRS, relying on definitions of "insurance" found in case law, determined that the plans provided for both risk shifting and risk distribution, qualifying them as insurance. Accordingly, even though the corporation is not licensed as an insurer in the state in which it does business, based on the character of the corporation's business activities, the IRS determined that the corporation is an "insurance company other than a life insurance company" for purposes of I.R.C. § 831.

**6. I.R.C. § 953 — IRS Grants Extension to Elect Domestic Corporate Status**

In PLR 200631007 (May 4, 2006), the IRS ruled that a foreign insurance company that had failed to timely elect for treatment as a domestic corporation for federal tax purposes under I.R.C. § 953(d) could have an additional 60 days to make that election. The IRS determined that the failure to make the election in a timely manner was due to reliance on advice from an accounting firm. The company was deemed to have acted reasonably and in good faith under current Treasury regulations, which provide that the IRS may grant an extension of time if the taxpayer was unaware of the necessity of the action because of reliance on erroneous advice, and if the taxpayer requests relief before the IRS discovers the failure to make the regulatory election.

**7. IRS and Treasury Release 2006-2007 Priority Guidance Plan**

On August 15, the IRS and Treasury jointly released the 2006-2007 Priority Guidance Plan, setting forth the tax-related guidance project that will be their focus for the next twelve months. The four projects listed for "Insurance Companies and Products" remain the same as in last year's plan: (1)

Guidance on the taxation of certain annuity contracts under I.R.C. § 72; (2) Guidance on the qualification of certain arrangements as insurance; (3) Guidance on the taxation of variable contracts as described in I.R.C. § 817(d); and (4) Final regulations under I.R.C. § 7702 regarding the attained age of the insured for purposes of testing the qualification of a contract as a life insurance contract (proposed regulations were published on May 24, 2005). Other guidance projects newly listed or continued to be listed that might be of interest to the insurance industry include —

- Regulations regarding the tacking rule for filing life/nonlife consolidated returns (Temp Reg. § 1.1502-47T was published on April 25, 2006).
- Final regulations under I.R.C. § 403(b) regarding tax-favored annuities purchased by section 501(c)(3) organizations or public schools (proposed regulations were published on November 16, 2004).
- Guidance on Health Savings Accounts.
- Final regulations under I.R.C. § 409A.
- Guidance regarding the application of I.R.C. § 409A to split-dollar life insurance.
- Guidance regarding reporting and income tax withholding under I.R.C. § 409A.
- Guidance on deductions for contributions to a welfare benefit fund.
- Guidance under I.R.C. § 419A on reserves for post-retirement medical and life insurance benefits.
- Guidance under I.R.C. § 468B regarding the tax treatment of a single-claimant qualified settlement fund.
- Regulations under I.R.C. § 468B regarding escrow accounts and other funds used in like-kind exchanges (proposed regulations were published on February 7, 2006).
- Guidance under I.R.C. §§ 6011, 6111 and 6112 regarding the application of the American Jobs Creation Act of 2004 to tax shelters.
- Regulations under I.R.C. §§ 6662A, 6662 and 6664 regarding accuracy-related penalties relating to understatements (interim guidance implementing changes made by the Jobs Act was issued as Notice 2005-12).
- Revisions to Circular 230 regarding practice before the IRS (proposed regulations regarding various general practice (nonshelter) matters were published on February 8, 2006; final regulations regarding matters relating to tax shelters, including standards for covered opinions and other written advice, were published on December 20, 2004).

## **8. Court Denies Discovery of Work-Product Documents**

In United States v. Roxworthy, No. 05-5776 (6<sup>th</sup> Cir. Aug. 10, 2006), the Sixth Circuit upheld a company's work-product claim and reversed a lower court's ruling that compelled a company to provide the IRS with certain documents prepared by an accounting firm analyzing the tax consequences of certain captive insurance transactions. In the facts of the case, the IRS is currently conducting an investigation into the company's tax liability for three open tax years. As part of the investigation, the IRS included in its discovery requests certain documents prepared for the company by an audit firm that analyzed the tax consequences of certain transactions and that discuss possible IRS arguments against the strategy that the

company intended to employ. At issue in the case was whether the documents had been prepared in anticipation of litigation or merely in the normal course of business to assist with tax return preparation. Documents which have been prepared in anticipation of litigation are shielded from discovery requests as “work-product” and do not need to be disclosed. The test adopted by the court was whether the document was created because of a party’s subjective anticipation of litigation, as contrasted with an ordinary business purpose, and whether that subjective anticipation of litigation was objectively reasonable. The court determined, through affidavits and testimony given by the company, that the documents were prepared in anticipation of litigation, and that they would not have been prepared otherwise. The court noted that to allow the IRS access to the documents also would allow them an unfair advantage by being privy to a detailed legal analysis of the strengths and weaknesses of the company’s legal position. The court concluded that the lower court erred in its order to compel discovery, and as a result, granted the company’s motion to quash the discovery order.

#### **9. Court Reverses Ruling on “Sham” Transaction**

In TIFD III-E, Inc. v. United States, 98 A.F.T.R.2d 2006-5616 (2d Cir. Aug. 3, 2006), the Second Circuit reversed and remanded a lower court’s ruling that had determined a taxpayer’s creation of a separate limited liability company, which was a partnership consisting of two Dutch banks and subsidiaries of the taxpayer, was not a sham designed to avoid taxes. Under the terms of the partnership, ninety-eight percent of the net operating income was allocated to the tax-exempt banks, while the remaining two percent was allocated to the subsidiaries. The lower court determined that there was economic substance to the creation of the partnership and that it was not a sham, and ordered the IRS to refund taxes paid to the taxpayer. On appeal, the Second Circuit concluded that the lower court used an inappropriate standard in making its determination. The court held that the test that should be applied is the “totality of the circumstances test” set forth by the United States Supreme Court, rather than merely the sham transactions test. That is, although there may have been a bonafide economic purpose for the transaction, the economic reality of the partnership agreement must be examined to determine whether the banks’ interest were debt or equity. The court determined that the banks did not share the risks of the partnership, and that their debt was secured by the company’s parent organization. In addition, the partnership agreement limited the banks’ receipt of the partnership’s economic return. Because of these determinations, the court concluded that the banks were not bonafide equity partners.

#### **10. Valuation Method Examined in Interest Swap Case**

In JPMorgan Chase & Co. v. Commissioner, Nos. 05-3730, 05-3742 (7<sup>th</sup> Cir. Aug. 9, 2006), the Seventh Circuit has remanded the case to the Tax Court to determine which method of calculating the fair market value of income derived from an “interest swap” transaction best reflects the income. An “interest swap” is an agreement between two parties to make periodic interest payments to each other on a set principal amount (the “notional amount”) for a specific term. Usually one party pays interest at a fixed rate and the other at a variable or floating rate based on a particular interest rate index (e.g., LIBOR). A particular party will profit or lose depending on whether the party correctly predicted the fluctuations in the interest rates; interest swaps are subject to investment risks from changes in interest rates, as well as the risk that the counter-party will fail to pay its obligation. In the case at issue, the IRS

and the taxpayer used disparate methods to calculate the fair market value of the interest swaps. At trial, the Tax Court initially determined that neither the IRS' nor the taxpayer's valuation method was correct, and instead crafted its own method of calculating the fair market value of the swaps. However, when the parties were unable to comply with all the requirements of the Tax Court's valuation method, the court adopted, without discussion, the IRS' valuation method. On appeal, the Sixth Circuit noted that the lower court had cited the "arbitrary and unlawful" standard when adopting the IRS' computation method, but had failed to analyze the IRS' valuation method under that standard. As a result, the case was remanded back to the Tax Court with instructions to analyze the IRS' method of valuation. If the Tax Court determines that the IRS' method is not arbitrary or unlawful, that method may be adopted and applied, or corrected.

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