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TAX ISSUES SUMMARY

September 30, 2006

***HIGHLIGHTS*:**

I.R.C. § 7702 — IRS Issues Final Regulations on Life Insurance Attained-Age Determinations

On September 12, the IRS issued final regulations (T.D. 9287) explaining how to determine the attained age of an insured for purposes of testing whether a contract qualifies as a life insurance contract for tax purposes. The attained age of an individual insured under a life insurance contract is either (a) the insured's age determined by his or her actual birthday, or (b) the individual's age determined by reference to the contract anniversary, so long as the assumed age under the contract is within 12 months of the actual age. For last-to-die contracts, the attained age of the insured is based on the attained age of the youngest individual insured, and for first-to-die contracts, the attained age is based on the oldest individual insured. See Policyholder Issues.

I.R.C. § 409 and 457 — Treasury Official Comments on Issuance of Final Regulations for Deferred Compensation Plans

An attorney in Treasury's Office of Tax Policy said on September 8 that the Treasury is moving forward with final regulations under I.R.C. § 409A, which are expected to be released this fall, though the effective date of January 1, 2007, set forth in the proposed regulations looks to be increasingly unworkable. One of the difficulties has been reconciling the deferred compensation regulation with other regulations that deal with split-dollar insurance arrangements. For this reason there may be special guidance for split-dollar insurance arrangements that will provide a "road map" for compliance. See Company Issues.

LEGISLATION

In General

Congress returned to session after Labor Day and adjourned yesterday, and in between accomplished nothing in the area of tax. With the Senate having failed to pass the "trifecta bill" (including provisions covering three areas: estate tax reform, the extender provisions, and an in the minimum wage) in August, there was discussion of bringing the trifecta bill up again in September, but with "sweeteners" added to attract the needed Democratic votes — but it did not happen. Chairman Grassley and Senator Baucus of the Senate Finance Committee urged that the extender provisions be added to other legislation or offered in a clean bill, but the Republican leadership disagreed with dismantling the trifecta bill. There was discussion of introducing another technical corrections bill that would cover what previously had been identified (in tax acts since 2001) and introduced earlier in the year, plus more technical directions for the recently enacted Pension Protection Act — but than also did not occur.

When Congress adjourned yesterday, predictors were pessimistic that any estate tax reduction legislation will occur this year. However, some hope was expressed that the extender provisions, along with appropriation bills, might be among the only things that Congress enacts during its lame-duck session scheduled to start in the middle of November.

POLICYHOLDER ISSUES

1. I.R.C. §§ 101(a)(2) — Transfer to Grantor Trust Is Not Transfer for Valuable Consideration

In PLR 200636086 (May 30, 2006), the IRS ruled that a taxpayer's transfer of variable life insurance contracts for valuable consideration to a trust that was treated as the grantor trust of the taxpayer was not a transfer for "valuable consideration" for purposes of the death benefit exclusionary rules of I.R.C. § 101(a). The death benefits under the transferred contracts would continue to be excludable because, for tax purposes, the taxpayer making the transfer owned both the contracts transferred and all the assets in the grantor trust used for consideration in the transfer. Thus, the taxpayer's transfer to the grantor trust for valuable consideration would be a transaction with himself and not recognized for tax purposes.

2. I.R.C. §§ 162 — Taxpayer Can Deduct Premiums Paid to a an Insurance Company Wholly-Owned by the Same Parent

In PLR 200636085 (May 30, 2006), the IRS ruled that a consolidated group of U.S. manufacturers ("Taxpayer") can deduct premiums for product liability and commercial risk insurance paid to a foreign insurance company that is a wholly-owned subsidiary of Taxpayer's foreign parent. In arriving at this conclusion, the IRS noted that Taxpayer and its subsidiaries have no ownership interest in the insurance company and described the insurance company as issuing policies for product liability and commercial risks that resembled risks covered by other commercial insurance companies. The insurance company issued policies to both Taxpayer and Taxpayer's foreign parent, along with the parent's diverse

group of subsidiaries and affiliates, issuing a minimum of four claims-related policies annually (one typically issued to the foreign parent, covering the losses of the parent and all its subsidiaries and affiliates worldwide (including Taxpayer), and the others naming Taxpayer and its subsidiaries as insureds). Further facts noted by the IRS were that (1) the risks inherent in the insurance company's policies were reasonable in view of the balanced geographical spread of risk exposure and product diversity involved; (2) the insurance company had entered into reinsurance agreements; (3) premiums are set based on the cost of insurance provided by unrelated commercial insurers; (4) the insurance company is adequately capitalized;(5) the foreign parent does not guarantee the insurance company's obligations; and (6) the insurance company does not make loans to the foreign parent. Having determined that the insurance company provided coverage for insurance risks and that the arrangements were regulated as insurance, the IRS found that the insurance company distributed the risks. Citing Rev. Rul. 2002-90, 2002-2 C.B. 985, the IRS concluded that the arrangements qualify as insurance contracts for federal income tax purposes. Accordingly, Taxpayer can deduct the premiums paid for the coverage as a business expense under I.R.C. § 162.

3. I.R.C. § 401(a)(9) — IRS Rules that Purchase of Annuity Contracts Will Not Result in a Taxable Distribution

In PLR 200635013 (June 6, 2006), the IRS ruled that the purchase of individual nontransferable fixed or variable annuity contract(s) by a trustee of a defined contribution, profit-sharing plan, using assets allocable to a deceased plan participant and naming the participant's designated beneficiary as the life annuitant and recipient of the annuity payments (i.e., the payments from the annuity contract being designed to meet the minimum distribution-at-death requirements of the qualified plan), will not be a taxable distribution from the plan to the designated beneficiary. Likewise, the distribution thereafter of the annuity contracts to the designated beneficiary will not result in a taxable distribution from the plan to the beneficiary.

4. I.R.C. § 7702 — IRS Issues Final Regulations on Life Insurance Attained-Age Determinations

On September 12, the IRS issued final regulations (T.D. 9287) explaining how to determine the attained age of an insured for purposes of testing whether a contract qualifies as a life insurance contract for tax purposes. The regulations specify that the attained age of an individual insured under a life insurance contract is either (a) the insured's age determined by his or her actual birthday, or (b) the individual's age determined by reference to the contract anniversary, so long as the assumed age under the contract is within 12 months of the actual age. For contracts that insure multiple lives on a last-to-die basis, the attained age of the insured is based on the attained age of the youngest individual insured. Similarly, for multiple-lives contracts that insure on a first-to-die basis, the attained age is based on the oldest individual insured. The regulations apply to life insurance contracts issued either after Dec. 31, 2008, or after September 30, 2007, if based on the 2001 commissioner's standard ordinary mortality and morbidity tables.

5. FASB Task Force Agrees on Liability Recognition for Split-Dollar Insurance Arrangements

On September 7, the Financial Accounting Standards Board's Emerging Issues Task Force (EITF) reached a decision on how an entity should account for deferred compensation and post-retirement benefit aspects of endorsement split-dollar life insurance arrangements. Specifically, it determined that the entity should recognize a liability for future benefits based on the agreement it has with the employee. Despite concern expressed by some entities, like banks, that they will have potentially large negative charges to their statements of financial position, the EITF noted that the purchase of the insurance contract does not settle the obligation and tentatively concluded, rather, that an entity should be viewed as having an obligation to provide a death benefit associated with the substantive agreement with an employee. The task force said the effective date of the proposal would be extended to fiscal years beginning after December 15, 2007, in order to give affected companies time to implement system and control changes, and to deal with regulators.

6. I.R.C. § 7702(f)(8) — Waiver Granted for Disqualified Life Contracts

In PLR 200635001 (May 23, 2006), the IRS granted a waiver under I.R.C. § 7702(f)(8) for disqualified life insurance contracts, allowing such contracts to be re-qualified based on plans to return excess premiums to the contractholders within 90 days and to prevent future failed contracts with a manual review process.

COMPANY ISSUES

1 . I.R.C. § 115 — IRS Rules that Company No Longer Qualifies for Exclusion

In PLR 200637031 (June 5, 2006), the IRS ruled that a captive insurance company that provides insurance and reinsurance coverage solely for municipalities, counties, schools and other public entities will no longer qualify to exclude its income as derived from the exercise of an essential governmental function under I.R.C. § 115(1), if it undertakes to provide coverage also for an organization that provides an insurance risk pool for three federally recognized Indian tribes. The IRS determined that, after the addition of the new entity, the beneficiaries of the coverage provided by the captive insurance company will no longer be limited to states, political subdivisions of states, or an entity the income of which is excludable under I.R.C. § 115. This would make the company ineligible to use the I.R.C. § 115(1) income exclusion.

2 . I.R.C. § 409— Treasury Official Comments on Issuance of Final Regulations for Deferred Compensation Plans

An attorney in Treasury's Office of Tax Policy said on September 8 that Treasury is moving forward with final regulations under I.R.C. § 409A, which are expected to be released this fall, though the effective date of January 1, 2007, set forth in the proposed regulations looks to be increasingly unworkable. One of the difficulties has been reconciling the deferred compensation regulation with other regulations that deal with split-dollar insurance arrangements. If the I.R.C. § 409A regulation requires changes in the split-dollar arrangement, such a change could be considered a "material change," which

would raise problems for grandfathered split-dollar insurance plans. For this reason there may be special guidance for split-dollar arrangements that will provide a "road map" for compliance.

3 . I.R.C. § 501(15) — Company Determined to Not Qualify as a Tax-Exempt Insurance Company

In PLR 200634049 (Dec. 9, 2005), the IRS ruled that a company that provided insurance policies to affiliates during certain tax years did not qualify for the I.R.C. § 501(c)(15) tax exemption for small insurance companies for such years. Because the company derived 95 percent of its premiums from policies issued to a related party, there was not transfer of risk from the related party to the company. The IRS indicated that, although there is no single factor which determines whether a company's primary and predominant business activity is insurance, case law on this matter defines insurance as having both risk-shifting and risk distribution. Since the IRS found that these factors were not present during tax years being considered, the IRS ruled that the company's primary and predominant activity was not insurance for those years, making the company ineligible for tax-exempt status under I.R.C. § 501(c)(15).

4 . I.R.C. § 842 — Domestic Asset/Liability and Yield Figures Announced

On September 8, the IRS announced the domestic asset/liability percentages and domestic investment yields for foreign life insurance and foreign property and liability insurance companies doing business in the United States. Rev. Proc. 2006-39, 2006-40 I.R.B. ___. The revenue procedure provides these taxpayers with instructions for computing estimated tax and making payments of estimated tax, for tax years beginning after December 31, 2004.

5 . I.R.C. § 987 — IRS Proposes Regulations to Tighten Rules for Reporting Gains and Losses Caused by Foreign Exchange Rates

On September 6, the IRS proposed regulations (REG-208270-86) aimed at tightening the rules for taxpayers calculating and reporting gains and losses of foreign branches based on fluctuations in foreign currency exchange rates. The proposed regulations are aimed at limiting a taxpayer's ability to trigger large non-economic losses. The proposed rules would establish a "foreign exchange exposure pool" and use a balance sheet approach to determine exchange gain or loss, which then would be recognized on a remittance. The regulations will not apply immediately to banks, insurance companies, and certain other financial entities, because the IRS wants comments on how these regulations should be designed to address the unique issues of these financial entities. For insurance companies, the IRS specifically wants comments on the proper treatment of insurance reserves, surplus, and the investment assets held by an insurance company. For example, the proper treatment of stock held in separate accounts of a I.R.C. § 987 qualified business unit of a life insurance company and the related insurance reserves for those separate accounts is an issue that needs further consideration. The IRS wants written or electronic comments submitted and received by December 6, 2006. Those wishing to discuss topics at a public hearing scheduled for November 21, 2006, should submit an outline by October 31, 2006.

6 . IRS Plans to Issue New Tax Shelter Regulations

An IRS official announced that the IRS plans to issue a new round of tax shelter regulations in the fall to replace the interim guidance issued after the American Jobs Creation Act of 2004. One change

being considered for the new regulations is whether to create a new category for transactions that the IRS would like information on, but that are not listed or reportable.

***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
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