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TAX ISSUES SUMMARY

November 30, 2006

***HIGHLIGHT*:**

I.R.C. §§ 6011, 6111 and 6112 — Proposed Regulations Provide Guidance on Reportable Transactions Rules and Material Adviser Disclosure Rules

The IRS has issued proposed regulations (REG-103038-05) that modify disclosure rules for reportable transactions under I.R.C. § 6011, as well as the rules for estate, gift, employment, and pension and exempt organization excise taxes that require the disclosure of listed transactions. The proposed regulations eliminate the reportable transaction category for "transactions with a significant book-tax difference," and add a new category, "transactions of interest." Also, the IRS has issued proposed regulations (REG-103039-05) that provide disclosure rules for material advisers under I.R.C. § 6111. The proposed regulations provide criteria for when a person is treated as becoming a material adviser as well as what information will be required on the Form 8918, Material Advisor Disclosure Statement. The IRS will issue a reportable transaction number to material advisors that file the Form 8918, and material advisors must give that number to all tax shelter clients. The only temporary and final rule (T.D. 9295) issued eliminates the tolling of the time for providing disclosure and maintaining lists when a taxpayer or material advisor requests a private letter ruling, effective for all ruling requests received after October 31, 2006. Comments and requests for a public hearing on the various proposed regulation packages are due by January 31, 2007. See Company Tax Issues.

LEGISLATION

In General

Congress will return next week to continue its lame-duck session with its primary goal being to work on appropriations and funding the federal government for the 2007 budget year. Because it is highly unlikely that the two houses actually can finish individual appropriation bills, the general

expectation is that Congress will pass a continuing resolution to cover federal government funding (based on last year's budget) through mid-February. On the tax front, there is continued jockeying to include other tax provisions (e.g., the repeal of the telephone excise tax and some pension reform technical corrections) with the expected passage of the "extender package" (which are the provisions that were expected to be included in a "trailer bill" earlier in the year — i.e., extension of the R&D credit, the state sales tax deduction, the work opportunity and welfare-to-work credits, the college tuition deduction, deduction for teacher out-of-pocket expenses, increased small business expensing limits, etc., and extension of the temporary "AMT fix"). In all events, the lame-duck session is expected to last no more than a week to ten days.

POLICYHOLDER ISSUES

1. I.R.C. § 72 — Sale Proceeds of Stock Received in a Demutualization Not a Policyholder Dividend

In Fisher v. United States, No. 04-1726T (Nov. 11, 2006), the Court of Federal Claims denied summary judgment to the parties, determining that certain issues must be resolved at trial. In the facts of the case, in 1990 a trust purchased a life insurance policy from Sun Life Assurance Company (Sun Life). The policy entitled the policyholder to receive dividends from the company which were declared out of surplus. The policyholder was also entitled to distributions from the company in the event of liquidation and to vote on certain matters. In 1999, the eligible policyholders of Sun Life voted to convert the company into a stock company. As part of this "demutualization," Sun Life distributed the full value of the mutual company to its participating policyholders through the issuance of stock shares of the newly-formed stock company. As an eligible policyholder, the trust transferred its voting rights and right to receive a distribution in the event of solvent liquidation to Sun Life for shares in the new stock company. Having sold its stock in the new company on the open market, the trust argued that proceeds from this sale should be treated as a distribution by Sun Life of a policy dividend and should be excluded from gross income under the rules of I.R.C. § 72. The court ruled that these proceeds were received as the result of a sale of stock and were not received "under" a life insurance contract, making I.R.C. § 72 "policyholder dividend" treatment inapplicable. The trust also argued that no capital gain should be realized on the sale of the stock because the trust's basis in the stock equaled the sale proceeds (reasoning that a portion of the premiums paid for the policy were for the voting and liquidation rights, which the trust exchanged for the stock). The court noted that the amounts of the premiums that should be attributed to the liquidation and voting rights is a material question of fact that must be determined at trial. The court therefore denied the plaintiff's motion and the defendant's cross-motion for summary judgment, and set a date for trial.

2. I.R.C. §§ 101 and 7702 — Waiver Granted for Contracts that Failed to Meet Requirements

In PLR 200646002 (Aug. 3, 2006), the IRS allowed certain universal life and variable universal life insurance contracts that failed to meet requirements of I.R.C. §§ 101(f) and 7702 to be corrected because it found that the failure was due to reasonable error. The companies that issued the contracts relied on several computer-based systems to monitor the contracts' compliance with the applicable code sections. Due to the failure of IT personnel to follow the companies' directions to

administer the contracts, errors in calculation occurred. Upon discovery of possible errors, the companies timely reviewed their procedures, discovered failures, requested waiver of errors, and instituted additional methods in order to avoid future errors. The companies plan to increase the death benefit payable to an amount that will ensure compliance with I.R.C. §§ 101(f) and 7702, and/or will refund to policyholders the amount of excess premiums with interest (using rates at least as high as those applied for purposes of crediting interest to each contract's cash value or, in the case of a variable universal life contract, rates at least as high as those applied for purposes of crediting interest to the contract's fixed account). The IRS determined that these remedial actions were appropriate and reasonable with respect to the errors that occurred, and granted the companies' waiver request.

3. I.R.C. §§ 871 and 1441 — Withdrawals from Accumulation Values of Annuity and Life Insurance Contracts Subject to U.S. Withholding Tax under Treaty with Canada

In CCA 200646001 (Aug. 14, 2006), the IRS interpreted the U.S. treaty with Canada and advised that income withdrawals from the accumulation value of annuity contracts and distributions of income from life insurance contracts issued by a U.S. life insurance company to a nonresident policyholder would be U.S.-source income generally subject to the U.S. 30-percent withholding tax under I.R.C. § 1441. Citing the analysis of Rev. Rul. 2004-74, 2004-2 C.B. 109, which ruled that income amounts paid to nonresident aliens from life insurance and annuity contracts sold through foreign branches of U.S. life insurance companies is U.S. source fixed and determinable annual and periodic income under I.R.C. §§ 871(a) and 1441, the CCA concludes that income amounts of such withdrawals and distributions likewise are U.S. source fixed and determinable annual and periodic income. The CCA notes that the Canada treaty provision for only a 15-percent U.S. withholding tax for "Pensions and Annuities" only applies to periodic annuity distributions and not to a withdrawal from an accumulation value. Withdrawals from an accumulation value of an annuity contract or a distribution from a life insurance contract are covered by the "Other Income" provisions, which does not limit the rate of U.S., making the 30-percent withholding tax applicable. The CCA also pointed out that the treaty's savings clause permitted the United States to tax U.S. citizens or former U.S. citizens as if not treaty existed, which would result in U.S. citizens (and, in certain cases, former U.S. citizens) not being subject to the U.S. withholding tax, but to net-basis U.S. tax on such withdrawals or distributions.

COMPANY ISSUES

1. I.R.C. § 409A — Compensation Plan Deferrals Reporting May Be Delayed

On November 14, IRS Compensation Branch Senior Counsel William Schmidt said that "it would not be surprising" if Code Y reporting were deferred again, although employers should be prepared to report the 2006 amount includible in gross income under Code Z. IRS Notice 2005-94, 2005-52 I.R.B. 1208 (Dec. 8, 2005) suspended Code Z and Code Y reporting and wage withholding requirements for I.R.C. § 409A deferrals of compensation for calendar year 2005. Final regulations under section 409A are expected to be published before 2007. Treasury Officials have noted that final regulations also will provide guidance or clarification regarding section 457(f) plans golden parachute gross-ups and other reimbursement arrangements, performance-based plans, and possibly additional plan categories, among other issues.

2. I.R.C. § 501(c) — IRS Rules Insurance Entity Not Exempt

In PLR 200644047 (Apr. 7, 2006), the IRS ruled that an organization no longer qualified for exempt status because it failed to show that it was engaged primarily in insurance activities. In the ruling, the IRS determined that the company did not have an insurance arrangement that met the risk-shifting and risk distribution requirements of the code to be considered an insurance company. The company had issued only one purported insurance contract in each of the years in question, and in that contract, named only one insured. The IRS relied on Rev. Rul. 2005-40, 2005-27 I.R.B. 4, which states that an arrangement does not qualify as insurance if the issuer of the contract enters into such contract with only one policyholder or if one insured accounts for 90% of the risks.

3. I.R.C. § 1502 — Reorganization Will Not Trigger Recognition of Parent Company's Deferred Intercompany Transactions

In PLR 200644021 (Jul. 28, 2006), the IRS ruled that a company that is reorganizing in order to combine subsidiaries into a single entity will continue to have its deferred intercompany transactions ("DITs") deferred after the reorganization. In the facts of the proposed reorganization, the parent company, which serves as the parent ("Parent") of a worldwide group of insurance and financial services corporations, owns all the common stock of FS1. FS1 is a foreign corporation, and owns all the stock of FS2, another foreign corporation. US Parent 1, a U.S. limited liability company that serves as a holding company and has elected under Treas. Reg. § 301.7701-3(a) to be treated as a corporation, is wholly-owned by FS2. US Parent 2, also a U.S. limited liability company that serves as a holding company and that has elected under Treas. Reg. § 301.7701-3(a) to be treated as a corporation, is wholly-owned by Parent. The Parent has two separate chains of U.S. subsidiaries and wants to combine the US Parent 1 and US Parent 2 consolidated groups under US Parent 2. The Parent has submitted an eight-step plan to achieve this reorganization. The IRS ruled that, after the reorganization, the US Parent 2 Group will include the successors to US Parent 1 and its subsidiaries. Accordingly, the US Parent 1's DITs will continue to be deferred.

4. I.R.C. §§ 6011, 6111 and 6112 — Proposed Regulations Provide Guidance on Reportable Transactions Rules and Material Adviser Disclosure Rules

The IRS has issued proposed regulations (REG-103038-05) that modify disclosure rules for reportable transactions under I.R.C. § 6011, as well as the rules for estate, gift, employment, and pension and exempt organization excise taxes that require the disclosure of listed transactions. The proposed regulations eliminate the reportable transaction category for "transactions with a significant book-tax difference," effective for transactions that would have to have been disclosed after January 5, 2006. A new category, "transactions of interest," has been added and will apply to transactions entered into after November 1, 2006. The regulations eliminate the special rule for lease transactions; those transactions will now be subject to the same disclosure rules as other transactions.

Also, the IRS has issued proposed regulations (REG-103039-05) that provide disclosure rules for reportable transactions by material advisers under I.R.C. § 6111. Under the statute, a person is a material advisor if the person provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction and directly or indirectly derives gross income in excess of a threshold amount for the material aid,

assistance, or advice. The proposed regulations provide criteria for when a person is treated as becoming a material adviser; that is, when the person (a) provides material aid, assistance, or advice, (b) receives gross income in excess of a threshold amount, and (c) the transaction is entered into by the taxpayer. The proposed regulations do not elaborate on the meaning of "insuring" in the definition of a material advisor, although the proposed regulations do include rules for disclosure by parties that provide third-party tax-result protection, which insures the tax benefits of a reportable transaction. Under the proposed regulations, the material advisor's required disclosure for a reportable transaction must include the names of other material advisers to the transaction and any designation agreement for maintaining lists to which the material adviser is a party, as well as a detailed description of the transaction and an itemized statement of information regarding the potential tax benefits. The IRS will issue a reportable transaction number to material advisors that file the Form 8918, Material Advisor Disclosure Statement, and material advisors must give that number to all tax shelter clients.

The only temporary and final rule (T.D. 9295) issued eliminates the tolling of the time for providing disclosure and maintaining lists when a taxpayer or material advisor requests a private letter ruling, effective for all ruling requests received after October 31, 2006. Comments and requests for a public hearing on the various proposed regulation packages are due by January 31, 2007.

5. I.R.C. § 6621 — Court Rules No Interest Netting Where Tax Year Ended Prior to Enactment of Law

In Federal National Mortgage Ass'n v. United States, No. 06-5055 (Fed. Cir. Nov. 11, 2006), the Court of Appeals for the Federal Circuit held that the taxpayer may not net interest payments for the tax year 1983, which was closed as of July 22, 1998, when I.R.C. § 6621(d) was enacted. I.R.C. § 6621(d) requires taxpayers to pay a higher rate of interest of tax underpayments than it requires the IRS to pay to taxpayers on overpayments, and also requires interest netting. A zero net interest rate applies when underpayments and overpayments occur in overlapping tax periods for the same taxpayer. After the code section was amended in 1998 to require interest netting, the Federal National Mortgage Association (FNMA) filed a claim requesting application of the zero net interest rate. The taxpayer and the IRS had entered into a settlement agreement in December 1990, and a refund was issued to the company. The court discussed the impact of the taxpayer signing a Form 870-AD settlement agreement, stating that such signing is "plainly a final determination." The court noted that neither the Form 870-AD nor a refund check by themselves would necessarily constitute a final determination, but that the form, coupled with resolutions of reserved issues, did constitute a "final determination." As a result, the court held that the period for the assessment of tax as agreed to by the parties ended 90 days after the date of the refund.

6. IRS Announces Formula to Estimate Refund of Telephone Excise Tax

Earlier this year, the Treasury announced that it would no longer collect the long-distance telephone excise tax and that it would provide refunds for taxes billed after February 28, 2003. In response to concerns raised by businesses and tax-exempt organizations and to decrease burdens, the IRS released a formula (IRS-2006-179) to allow such businesses and organizations to estimate the refund due

to them. To receive a refund, the taxpayer must file a Form 8913, Credit for Federal Telephone Excise Tax Paid. The taxpayer may either request the actual amounts paid from February 2003 through October 2006, or the estimated amount as calculated by the formula.

***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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