

# 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

December 26, 2006

### **HIGHLIGHTS:**

#### **I.R.C. § 461 — Liability for Services or Insurance Is Not Fixed on Execution of the Contract**

In Rev. Rul. 2007-3, 2007-4 I.R.B. \_\_\_, the IRS ruled that a liability for services or insurance is not fixed under I.R.C. § 461 by the mere execution of the contract for the future provision of services or insurance. Rather, all events have occurred to establish liability only when the event fixing the liability has occurred or payment is due, whichever is earlier. In simultaneously released Rev. Proc. 2007-14, 2007-4 I.R.B. \_\_\_ (Dec. 21, 2006), the IRS explains the procedures for obtaining automatic consent under I.R.C. § 446(e) to change accounting methods for liabilities for services or insurance to comply with Rev. Rul. 2007-3. See Policyholder Issues.

#### **I.R.C. §§ 832 and 846 — IRS Publishes Loss Payment Patterns, Discount Factors, and Salvage Discount Factors for 2006**

The IRS issued Rev. Proc 2007-9, 2007-3 I.R.B. \_\_\_ on December 14<sup>th</sup>, which prescribes the loss payment patterns and discount factors for the 2006 accident year. The procedure applies to taxpayers required to discount unpaid losses under I.R.C. § 846, which provides that discounted unpaid losses must be separately determined for each accident year of each line of business. The IRS also issued Rev. Proc. 2007-10, 2007-3 I.R.B. \_\_\_, which prescribes the salvage discount factors to be used for computing discounted estimated salvage recoverable under I.R.C. § 832. See Company Issues.

## LEGISLATION

### **In General**

During a one week lame-duck session, Congress passed stopgap funding for the government (i.e., a continuing resolution until mid-February) and the Tax Relief and Health Care Act of 2006, which President Bush signed into law on December 20<sup>th</sup>. The Tax Relief and Health Care Act of 2006 combines extensions of several tax relief measures (e.g., the research and development credits, state sales

tax deductions, work opportunity and welfare-to-work credits, college tuition deductions, deductions for out-of-pocket teacher expenses, increased small business expensing, etc.) with various trade and healthcare provisions. The legislation contains provisions to make HSAs more attractive, allowing penalty-free transfers from FSAs and HRAs to HSAs until 2012; allowing one-time rollovers from individual retirement accounts; allowing people to contribute up to the annual limit of \$2850 regardless of the deductible for their insurance plan; and allowing them to fully fund their HSAs regardless of what time in the year they sign up.

When Congress returns in January, the Democrats will be in charge of both houses, and both tax-writing committees. One area to which the tax-writing committees might be expected to turn their immediate attention will be the alternative minimum tax (AMT). After losing out to extension of lower rates for capital gains and dividend income in last year's reconciliation bill, an extension of the AMT patch aimed at keeping more individuals from falling into the AMT system likewise was not part of the Tax Relief and Health Care Act of 2006. As always, the issue for any AMT "fix" (whether temporary or permanent) will be revenue. As estimators have continued to point out, in just a few years, it will cost less to repeal the regular tax than the AMT. The pressure of the impact of the AMT system on more individuals, combined with the Democrats desire to reinstate pay-go rules for both tax and spending provisions, will mean that Congress will be looking hard for loop-hole closers and potential revenue raisers in 2007.

## **POLICYHOLDER ISSUES**

### **1. Court Refuses to Dismiss Tax Shelter Case**

In Kennard v. Indianapolis Life Insurance, Co., No. 3:05-CV-1247-G (N.D. Tex. Nov. 13, 2006), a district court denied a defendant's motion to dismiss, which argued that a single letter (containing alleged misrepresentations about a pension plan) sent by him to the plaintiff in Texas was insufficient to establish personal jurisdiction over him. The court determined that the letter did sufficiently establish the requisite contact necessary for personal jurisdiction over the defendant. The court also disagreed with the defendant's argument that the plaintiff had not complied with the Texas long-arm statute which provides for substitute service of process on a non-resident; while acknowledging that not every element of substituted service was met, the court found that overall the requirements of the long-arm statute were met. For these reasons, the court denied Harrington's motion to dismiss. For background on the case, see TAX ISSUES SUMMARY, March 2006.

### **2. I.R.C. § 461 — Liability for Services or Insurance Is Not Fixed on Execution of the Contract**

In Rev. Rul. 2007-3, 2007-4 I.R.B. \_\_\_ (Dec. 21, 2006), the IRS ruled that a liability for services or insurance is not fixed under I.R.C. § 461 by the mere execution of the contract for the future provision of services or insurance. Rather, all events have occurred to establish liability when the event fixing the liability has occurred or payment is due, whichever is earlier. The ruling considered two situations of contracts executed in 2006, with the taxpayers using the recurring item exception under Treas.

Reg. § 1.461-5. In the first, a calendar-year, accrual taxpayer entered into a contract for the provision of services between January 15<sup>th</sup> and December 31, 2007; payment was due and paid when the taxpayer began receiving services. In the second, a taxpayer entered into a contract for insurance from January 15<sup>th</sup> to December 31, 2007; the premium payment was made on the January 15<sup>th</sup> due date. The IRS explained that in both situations liability could be established on January 15<sup>th</sup> because services were provided and payment was made; execution of the contract was not sufficient to establish liability in 2006.

In simultaneously released Rev. Proc. 2007-14, 2007-4 I.R.B. \_\_ (Dec. 21, 2006), the IRS explains the procedures for obtaining automatic consent under I.R.C. § 446(e) to change accounting methods for liabilities for services or insurance to comply with Rev. Rul. 2007-3.

### **3. I.R.C. §§ 1001 and 1035 — Partition of a Life Insurance Contract Not a Sale**

In PLR 200651023 (Sept. 21, 2006), the IRS ruled that the partition of a life insurance contract between two banks in proportion to the banks' respective ownership of the contract originally will not be treated as a sale, cause either bank to recognize income or affect the issue dates or validity of the resulting contracts.

### **4. NAIC Committee Moves Toward Ban on Investor Initiated Life Insurance Policies**

On December 11<sup>th</sup> the Life Insurance and Annuities Committee of the National Association of Insurance Commissioners (NAIC) adopted amendments to the Viatical Settlements Model Regulation which would have the effect of imposing a five-year ban on life insurance policies that are financed with the specific intent to be sold to investors. Investor-Initiated Life Insurance (also called Stranger-Originated Life Insurance (SOLI) or Speculator-Initiated Life Insurance (SPIN-LIFE)) is an emerging type of life insurance policy that is financed and purchased with the intent of selling it to a life settlement company.

## **COMPANY ISSUES**

### **1. I.R.C. § 409A — IRS Issues Guidance on Deferred Compensation Reporting, Withholding Requirements**

In Notice 2006-100, 2006-51 I.R.B. 1109 (Dec. 1, 2006), the IRS issued interim guidance regarding wage withholding and reporting requirements for calendar years 2005 and 2006 for deferrals of compensation and amounts includable in gross income under I.R.C. § 409A. The notice says that employers and payers are not required to report amounts deferred during the year under a nonqualified deferred compensation plan for years 2005 and 2006 on Form W-2 or Form 1099-MISC. However, under the notice, amounts includable in gross income under I.R.C. § 409A must be treated as wages for income tax withholding purposes and reported for calendar year 2006. The notice also provides for the calculation of additional tax for plans that should have been grandfathered but were materially modified after October 3, 2004, as well as for the calculation of penalties. This notice supercedes Notice 2005-94,

2005-52 I.R.B. 1208, which suspended the employer and payer reporting and wage withholding requirements for 2005 deferrals of compensation. Under the new guidance, employers who did not report 2005 deferrals of compensation are required to file an original or corrected information return and furnish corrected payee statements for calendar year 2005. Comments on pending guidance on income inclusion requirements, additional taxes, and the reporting and withholding requirements of I.R.C. § 409A are due by March 19, 2007.

**2. I.R.C. § 482 — IRS Postpones Temporary Services Rules Except for ‘Business Judgment’ Provision**

In Notice 2007-5, 2007-3 I.R.B. \_\_\_ (Dec. 20, 2006), the IRS announced that it is postponing for one year the effective date for most provisions in its intercompany services and intangibles regulations. However, the effective date of the business judgment rule remains unchanged, and will still go into effect January 1, 2007. The business judgment rule states that the services cost method (SCM) may not be applied if the service significantly contributes to key competitive advantages, core capabilities, or fundamental success or failure of the business. The reason given for the postponement of the rest of the regulations package is that the IRS recognized that a large volume of intragroup back-office services common to many industries will potentially be affected by them. The remaining provisions will be effective January 1, 2008.

The SCM replaces the simplified cost-based method present in the 2003 proposed rules, and allows taxpayers to charge costs for services listed on the IRS’ “white list” and for services with a median comparable arm’s-length markup of seven percent or less. In Rev. Proc. 2007-13, 2007-3 I.R.B. \_\_\_ (Dec. 20, 2006), the IRS expanded the white list substantially, increasing the number of eligible SCM services to 101 from 48. Two eligible services of note are numbers 97 and 98, listed under the title of “Insurance Claims Management.” Service 97 is listed as “[s]ecuring insurance coverage for general, product, and worker’s compensation liability, property loss, business interruption, and other business risks.” Service 98 is listed as “[c]oordinating with third party insurers, with respect to insurance policies, including preparing claims for submission to such third party insurers.”

**3. I.R.C. § 807 — ACLI Seeks Meeting with Treasury on New Insurance Reserve Computation Methodologies**

In a letter dated December 7<sup>th</sup>, Ann Cammack of the ACLI requested meetings with Treasury officials to discuss reserve modernization efforts affecting life insurance and variable annuity contracts. The letter follows up on a meeting between ACLI representatives and Treasury officials that occurred on September 21, 2006.

**4. I.R.C. §§ 832 and 846 — IRS Publishes Loss Payment Patterns, Discount Factors, and Salvage Discount Factors for 2006**

The IRS issued Rev. Proc 2007-9, 2007-3 I.R.B. \_\_\_ on December 14<sup>th</sup>, which prescribes the loss payment patterns and discount factors for the 2006 accident year. The procedure applies to taxpayers required to discount unpaid losses under I.R.C. § 846, which provides that discounted unpaid losses must

be separately determined for each accident year of each line of business. The IRS also issued Rev. Proc. 2007-10, 2007-3 I.R.B. \_\_\_\_, which prescribes the salvage discount factors to be used for computing discounted estimated salvage recoverable under I.R.C. § 832. Both procedures include tables of the relevant factors.

#### **5. I.R.C. § 6111 — IRS Clarifies Material Advisor Disclosure Rules Proposed Regulations**

The IRS issued a clarification to proposed regulations REG-103039-05 (71 FR 64496) relating to the disclosure of reportable transactions by material advisors. The corrected publication changes a portion of § 301.6111-3 from “disclosure of the tax structure or tax aspects of the transaction is limited in” to “disclosure of the tax treatment or tax structure of the transaction is limited in” (emphasis added). The notice states that the correction is necessary because as originally written, the line could be misleading.

#### **6. IRS Limits Duration on Continuous Audits of Taxpayers**

In Policy Statement 4-5, released November 27<sup>th</sup>, the IRS said that IRS examiners and specialists may not examine or survey the same taxpayer for more than five consecutive years from the case assignment date. An IRS spokeswoman, in a November 28<sup>th</sup> statement to BNA, wrote that the policy was updated to reflect recent organizational changes and the IRS’ belief that there should be clearer definitions of how long examiners and managers should remain assigned to taxpayers due to the 2004 Sarbanes-Oxley Act. Some deviations from the policy are permitted if approved by an IRS director or IRS deputy commissioner for services and enforcement. The statement also specifies that LMSB team managers and TE/GE team examination managers should not be reassigned to the same taxpayer for at least one intervening examination or two intervening surveys. The statement took effect February 9, 2006.

#### **7. Illinois Court Upholds Retaliatory Tax on Alien Insurer**

In Sun Life Assurance Co. of Canada v. Manna, No. 1-05-1323, (Ill. App. Ct. Nov. 1, 2006), an Illinois appellate court has held that a “retaliatory tax” imposed on a Canadian insurance company by the state is constitutional. The tax that is the focus of this case is one imposed on a foreign (non-Illinois) or alien (non-U.S.) insurance company by the state of Illinois. The tax is imposed as a condition of the company’s doing business in the state when the state or country in which the company is incorporated would require a similarly-situation Illinois-domiciled company to pay a greater amount of insurance taxes as a condition of doing business there. The insurance company argued that the tax violates the Uniformity Clause of the Illinois Constitution, as well as the Equal Protection and Commerce Clauses of the U.S. Constitution. The court held that the Uniformity Clause of the Illinois Constitution was not violated because the tax serves a legitimate purpose and is applied to all alien insurers equally. The court noted that the Uniformity Clause imposes more stringent limitations than the Equal Protection Clause of the U.S. Constitution, and so held that there was no Equal Protection violation either. Finally, the court held that the Commerce Clause was not violated because under the McCarran-Ferguson Act (15 U.S.C.A. §§ 1011-1015), there is no restriction upon a state’s power to tax the insurance business. The court relied

primarily on case law to support its reasoning and noted that, if Congress had intended that states could tax only interstate (as opposed to international) commerce, Congress would have made that restriction clear. The court further noted that there is no Supreme Court precedent interpreting the McCarran-Ferguson Act to include such restrictions either.

#### **8. FASB Acts on Mortgage Guaranty and Credit Insurance, and on the Bifurcation Issue**

The Financial Accounting Standards Board said on November 29<sup>th</sup> that it would not include mortgage guaranty insurance and credit insurance contracts in a proposed interpretation on FASB Statement No. 60. A FASB staff member said that the Board will issue an exposure draft on the interpretation for a 90-day public comment period in upcoming weeks. Also discussed at the November 29<sup>th</sup> meeting were the definition of expected loss, interest rates used in discounting, and accounting for refundings of guaranteed financial obligations. The Board, in discussion of the definition of expected loss, said it would not define “watch list” categories or a minimum threshold, leaving companies to determine a pre-claim liability based on the credit deterioration or other factors experienced from the “watch list”. In addition, the FASB ratified four Emerging Issues Task Force final consensuses and two tentative conclusions.

On December 6<sup>th</sup> the FASB said it would no longer pursue the issue of bifurcation of insurance and reinsurance contracts for financial reporting as part of its discussions relating to its insurance risk transfer project. The FASB had invited comment on bifurcation in May. The comments received indicated that bifurcation would be too costly, complex, and arbitrary, and that the same reporting issues can be addressed by providing more implementation guidance or disclosures. The FASB said that it will focus on developing enhanced insurance and reinsurance disclosures that highlight risk-limiting features. In addition, it plans to develop additional language around the current FASB Statement No. 113 guidance to increase the level of risk transfer required for a contract to be accounted for as insurance.

#### **9. SEC Does Not Expect Full FIN 48 Disclosures in Interim Periods; Practice Guide on FIN 48 Made Available**

Carol Stacey, chief accountant for the Securities and Exchange Commission’s Corporation Finance Division, said on November 17<sup>th</sup> that the SEC’s staff is not expecting companies to disclose the full tabular roll-forward presentation of unrecognized tax benefits in interim financial reporting periods under the Financial Accounting Standards Board’s Interpretation No. 48 (FIN 48), “Accounting for Uncertainty in Income Taxes.” Stacey said that companies should use their judgment on what to disclose in interim periods under FIN 48. On November 21<sup>st</sup>, a panel of the American Institute of Certified Public Accountants (AICPA) issued a document (CPCAF Alert #138) discussing FIN 48 implementation issues that also reflects that SEC perspective. According to the AICPA, that document detailed disclosure recommendations of the AICPA’s SEC Regulations Committee, to which the SEC agreed. The discussion document says that companies should disclose their total amount of unrecognized tax benefits as of the date of adoption, but that tabular reconciliation is not required for interim periods.

The AICPA has made available a practice guide on accounting for uncertain tax positions under FIN 48. The guide is free and offers a summary of FIN 48 and discusses related accounting, auditing, and tax issues. The guide may be downloaded at:

<http://tax.aicpa.org/Resources/Professional+Standards+and+Ethics/Practice+Guide+on+Accounting+for+Uncertain+Tax+Positions+Under+FIN+48.htm>.

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