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TAX ISSUES SUMMARY

February 28, 2007

HIGHLIGHTS:

Administration Releases FY 2008 Budget

On February 5th, the Administration released its proposed 2008 Budget. The proposed budget includes provisions for (1) nondeductible contributions of up to \$2,000 annually for Lifetime Savings Accounts (LSAs), (2) Retirement Savings Accounts (RSAs), allowing an annual nondeductible contribution of up to \$5,000 and replacing Roth IRAs, (3) the consolidation of 401(k), SIMPLE 401(k), 403(b), 457, SIMPLE IRAs and SARSEPs into a single plan type — the Employee Retirement Savings Account (ERSA), which would have simpler rules, (4) a \$15,000 deduction for both income and payroll taxes for families who purchase health insurance that meets minimum requirements, with a flat deduction replacing the existing exclusion for employer-provided health insurance, the self-employed premium deduction, and the medical itemized deduction for those under 65 years of age, and (5) expansion of HSAs. See Legislation.

I.R.C. § 404 — IRS Rules on Timing of Deferred Compensation Accrual

In Rev. Rul. 2007-12, 2007-11 I.R.B. ____, the IRS ruled that the I.R.C. § 404 deduction rule for deferred compensation does not alter the timing of the accrual of a company's payroll tax liability under I.R.C. § 461, so long as the employer has met the all-events test and the recurring item exception prescribed in I.R.C. § 461. See Company Issues.

LEGISLATION

1. Administration Releases FY 2008 Budget

On February 5th, the Administration released its proposed 2008 Budget. There are no provisions specifically aimed at insurance companies or their products, but there are several provisions worthy of note. The proposed budget includes a provision for nondeductible contributions of up to \$2,000 annually for Lifetime Savings Accounts (LSAs). Amounts would be allowed to be withdrawn at any time for any purpose without restriction or tax. The proposed budget also includes a provision for Retirement Savings Accounts (RSAs), allowing an annual nondeductible contribution of up to \$5,000. RSAs would replace Roth IRAs, with existing Roth IRAs converting to RSAs subject to the new rules. The Administration's budget proposes that 401(k), SIMPLE 401(k), 403(b), 457, SIMPLE IRAs and SARSEPs be consolidated into a single plan type — the Employee Retirement Savings Account (ERSA). ERSAs would have simpler rules and would include safe-harbor provisions, such as a 50% employer match on contributions up to six percent of employee compensation. Generally, ERSAs would follow existing 401(k) plan rules.

The proposed budget also contains provisions for information reporting for payments to corporations, reporting of basis on sales of securities, an expansion of broker information reporting, reporting of merchant payment card reimbursements, requiring certification of TINs from non-employee service providers, and increased reporting for certain payments by government. The penalty for failing to properly report information would increase.

The budget includes a proposal for a \$15,000 deduction for both income and payroll taxes for families who purchase health insurance that meets minimum requirements. The full deduction would be allowed regardless of actual cost so long as the insurance qualifies. This flat deduction would replace the existing exclusion for employer-provided health insurance, the self-employed premium deduction, and the medical itemized deduction for those under 65 years of age. Health Savings Accounts (HSAs) would be expanded and be made more flexible.

2. Small Business Tax Package Approved by the House

The House Ways and Means Committee approved, and then the full House passed, the chairman's mark of a \$1.3 billion package of tax breaks for small businesses which can be attached to the minimum wage bill for conferencing with the Senate. The Small Business Tax Relief Act of 2007 (H.R. 976) would extend through 2010 small business expensing under I.R.C. § 179 and increase the total amount of expensing allowed to \$125,000, extend through 2008 the work opportunity tax credit and expand eligibility for the credit, freeze the minimum wage level for purposes of calculating the tip credit, waive the individual and corporate alternative minimum tax limitations on the work opportunity tax credit and the tip credit, and allow an unincorporated business jointly owned by a married couple to file as a sole proprietorship without penalty. The House small business tax provisions cost significantly less than those passed by the Senate, so the eventual conference on the minimum wage bill, with the small business tax provisions, is not expected to be easy.

POLICYHOLDER ISSUES

1. I.R.C. § 101 — IRS Rules Contract Exchange Not a Transfer

In Rev. Rul. 2007-13, 2007-11 I.R.B. ____, the IRS ruled that the grantor who is treated as the owner of a trust possessing a life insurance contract on his own life is treated as the owner of the contract for purposes of the transfer-for-value rules. Thus, when one grantor trust transfers the life insurance contract on the grantor's life to another grantor trust owned by the grantor, in exchange for cash, there is not transfer for a valuable consideration under I.R.C. § 101(a)(2). In the situation where a contract on the grantor/insured is transferred from a trust that is not a grantor trust (with the result that the grantor was not treated as the owner of the contract) to a grantor trust in exchange for cash, there is a transfer for valuable consideration. However, in the latter situation, the transfer-for-value limitations of I.R.C. § 101(a)(2) do not apply because the transfer to the grantor trust is treated as a transfer to the grantor/insured within the meaning of I.R.C. § 101(a)(2)(B).

2. I.R.C. § 1001 — Public Comments on Proposed Regulations

Several comment letters have been submitted to the Treasury criticizing proposed regulations (REG-141901-05) covering the exchange of property for an annuity. Ostensibly the proposed regulations were designed to deal with the problem of some taxpayers inappropriately avoiding or deferring gain on the exchange of highly appreciated property for the issuance of private annuity contracts issued by family members or by business entities that are controlled by the annuitants or their family members. The proposed regulations provide that, if an annuity contract is received in exchange for property (other than money), (i) the amount realized attributable to the annuity contract is the fair market value of the annuity contract at the time of the exchange; (ii) the entire amount of the gain or loss, if any, is recognized at the time of the exchange, regardless of the taxpayer's method of accounting; and (iii) for purposes of determining the initial investment in the annuity contract under section 72(c)(1), the aggregate amount of premiums or other consideration paid for the annuity contract equals the amount realized attributable to the annuity contract (the fair market value of the annuity contract). The primary criticism in the comment letters is that the actual incidence of abuse of such transactions is minimal, and that the proposed regulations are overly broad and would hinder law-abiding taxpayers' ability to legitimately use annuities for estate-planning purposes.

3. MetLife Comments on Designated Roth Contribution Rules

A MetLife representative submitted a letter to Treasury recommending the adoption of a "one-contract" approach to Roth IRA contributions. In a letter, dated December 15, 2006, Kenneth Eisenberg of Metropolitan Life Insurance Co. recommends that proposed regulations on designated Roth contributions should allow a Roth IRA account to be offered along with a Traditional 403(b) or 401(k) account under a single annuity contract. Eisenberg explains that such a provision would result in a reduction of withdrawal charges and annual charges, and would be more convenient for participants who would not need to complete a new application to start making Roth IRA contributions.

4. Comments Requested on New Information Reporting Forms to Be Filed by Charities Having Interests in Life Insurance Contracts

The IRS issued Notice 2007-24 (Feb. 23, 2007) inviting public comment on draft IRS forms to implement a new information reporting requirement for charities and certain other entities with respect to certain structured insurance contracts and also with respect to a Congressionally-mandated study being conducted by the Treasury and IRS. The study being conducted was mandated by Section 1211 of the Pension Protection Act of 2006 and requires the Treasury and the IRS conduct a study on tax-exempt organizations engaging in transactions involving life insurance contracts which provide investors the benefits of the tax-exempt organization's insurable interest in individuals insured under certain life insurance contracts. In order to gather the information for the study, the IRS has issued two draft forms, Form 8921 and Form 8922. Comments on the forms should be received by March 16, 2007. Comments regarding the study in general should be submitted by August 22, 2007.

COMPANY ISSUES

1. I.R.C. § 61 — IRS Rules on Former Executive's Use of Corporate Aircraft

In PLR 20070510 (Feb. 2, 2007), the IRS ruled that flights on a corporation's aircraft enjoyed by a former CEO and his or her spouse following the CEO's resignation, but during a time when the former CEO continued to provide consulting services to the corporation, did not result in income to the former CEO. The former CEO, as an independent contractor, qualified as an "employee" for purposes of receiving a working condition fringe benefit under I.R.C. § 132(d). However, after the term of the services agreement that details the consulting services ends, the former CEO will fail to qualify as an employee. Because the former CEO and spouse qualify as "control employees" under Treas. Reg. § 1.61-21(g), flights provided after the service contract runs out must be valued at 400% of the standard industry fare, the CEO will have income to the extent that amount exceeds the safe harbor airfare amount, and the use of the aircraft will constitute "wages" subject to reporting on Form W-2.

2. I.R.C. § 404 — IRS Rules on Timing of Deferred Compensation Accrual

In Rev. Rul. 2007-12, 2007-11 I.R.B. ____, the IRS ruled that the I.R.C. § 404 deduction rule for deferred compensation does not alter the timing of the accrual of a company's payroll tax liability under I.R.C. § 461, so long as the employer has met the all-events test and the recurring item exception prescribed in I.R.C. § 461. The company that requested the ruling uses an accrual method of accounting and files its federal income tax returns on a calendar year basis. At the end of Year 1, all events had occurred to establish the liability the company owed as FICA and FUTA taxes related to the compensation that was deferred, and the amount of payroll tax liability could be determined with reasonable accuracy. The company properly adopted the recurring item exception allowed under Treas. Reg. § 1.461-5 with respect to the payroll taxes. The payroll taxes generally would be treated as having been incurred in Year 1, even though the compensation was deferred and only allowed to be deducted under I.R.C. § 404 in Year 2. In the revenue ruling, the IRS reasons that I.R.C. § 404 applies to compensation paid or accrued by an employer under a deferred compensation plan, but that an employer's liability for payroll taxes does not represent such compensation. For that reason, I.R.C. § 404 does not control the deductibility of an employer's liability for payroll taxes, and thus does not alter the

timing of the accrual of the company's payroll tax liability under I.R.C. § 461. The company, therefore, may treat its payroll tax liability as incurred in Year 1, though the compensation related to the liability is deductible in Year 2.

3. I.R.C. § 501 — Insolvent Insurance Company Qualifies for Transition Rule

In PLR 200705030 (Nov. 9, 2006), the IRS ruled that an insolvent insurance company in supervised liquidation will not suffer any adverse federal tax consequences under I.R.C. § 501(c)(15) in connection with its receivers final creditor distributions and closing of the receivership estate. The company requested the ruling because, as a result of the transfers of policies according to the liquidation plan, it no longer qualifies as an insurance company under I.R.C. § 816(a). The IRS determined that the company met requirements for the special transition rule for insurance companies in liquidation or receivership under the Pension Funding Equity Act, Pub. L. No. 108-18 (2004) and therefore qualifies for an exemption from tax under I.R.C. § 501. The Act's transition rule provision does not extend to exempt tax beyond December 31, 2007, so the IRS noted in its ruling that the company should wind up all remaining transactions prior to that date, or else the additional transactions giving rise to income will not be exempt.

4. I.R.C. § 6011 — ACLI Comments on Proposed Regulations

In a comment letter dated January 31, 2007, the ACLI discussed two aspects of proposed regulations on disclosure of reportable transactions under I.R.C. § 6011 that it says will cause administrative difficulties for its members. The first issue the letter addresses is the new category of "transactions of interest" in the proposed regulations. The primary concern relating to the reporting of these transactions is that the regulations would apply retroactively, requiring disclosure for any occurrences going back to November 2, 2006. The ACLI notes that this requirement would be overly burdensome and suggests that the look-back period be limited to a period of 90 days from the date of any published guidance. Another concern with "transactions of interest" deals with the definition and the confusion that may arise regarding whether a transaction is "substantially similar" to a transaction of interest, believing that such a standard is overly broad. Furthermore, an item listed as a "transaction of interest" may be seen as "tainted" in the eyes of the public. The ACLI recommends that designations of transactions of interest be as specific and clear as possible to avoid undue burdens on taxpayers tasked to analyze how or whether to report transactions as "transactions of interest." In addition, the letter urges that there be a timely review and evaluation of disclosure materials related to transactions of interest, and that such transactions either become listed transactions or removed from the roll of transactions of interest within a specified period of time.

The second issue discussed in the letter relates to the timing for filing Schedules K-1. The proposed rule is that, if a timely Schedule K-1 that leads the taxpayer to determine that it has a reportable transaction is received less than 10 calendar days before the due date for the return, the taxpayer will not be considered late in filing if it files a disclosure statement within 45 days of the return due date. The ACLI feels this time frame is not practical given the amount of time necessary to finalize taxable income computations and recommends that the time be increased to 30 days and 90 days, respectively.

5. I.R.C. § 6621 — Interest Netting Not Allowed Between Consolidated Group's Overpayment and Member's Underpayment

In CCA 200707002 (Dec. 20, 2006), the IRS advised that I.R.C. § 6621(a) interest netting is not allowed between an overpayment of a consolidated group's income tax for one year and either a separate return underpayment of a member's prior year income tax or a separate return underpayment of a member's employment or excise tax for the same year. To qualify for I.R.C. § 6621(a) interest netting, the same taxpayer must have incurred both the underpayment and made the overpayment. The facts in the advice are, generally, that Corporation A filed a separate return for year 1 and paid underpayment interest. In year 2, Corporation A joined a consolidated return with Corporation B as the common parent. The consolidated tax was overpaid and overpayment interest was allowable. For year 2, A filed separate employment and excise tax returns, which also were underpaid. The IRS reasoned that there is no basis to treat a member of a consolidated group with a separate return underpayment as the same taxpayer responsible for an overpayment. Because the consolidated group and the subsidiary member filing a separate return are not the "same taxpayer" for purposes of the overpayment and the underpayment, interest netting between the two is not allowed. Comment: Based this ruling, a taxpayer also may assume that the IRS will not permit interest netting between an underpayment from a separate return year and an overpayment from the consolidated return, even where it could be shown that the same taxpayer that paid the underpayment also generated the overpayment on the consolidated return. We would expect the position set forth in the CCA to be challenged.

6. Court Refuses to Impose Penalties in *Klamath* Case

In Klamath Strategic Investment Fund LLC v. United States, No. 5:04-cv-00278 (E.D. Texas, Jan. 31, 2007), a federal district court in Texas held that a Son-of-Boss-type foreign currency transaction was an economic sham and thus disallowed the taxpayers' partnership losses in a TEFRA proceeding. However, the court ruled that substantial understatement penalties could not be imposed because the taxpayers had substantial authority for their return position. In its opinion, the court did not elaborate on what constituted the substantial authority for the taxpayers' return position, rather it simply noted that the LLCs through which the taxpayers invested in the structured transaction obtained "comprehensive opinions" on which the taxpayers relied before they filed their returns. In a discussion of substantial authority, the court noted that tax opinions themselves cannot form the basis for substantial authority, but noted that the taxpayers' expert witness testified that their return positions were supported by substantial authority under the tax laws. On this basis, the court found that the taxpayers had substantial authority for their return position and that a substantial understatement penalty could not be imposed. In other words, the court held that the discussion of substantial authorities in a tax opinion and a tax-law expert witness's testimony regarding the authorities discussed in the tax opinion can help establish substantial authority, but that the fact that the taxpayers obtained the opinion standing alone cannot.

7. *Principal Life* Court Will Not Reconsider IRS Recoupment, Offset Claims

In Principal Life Ins. Co. v. United States, No. 02-1278T, the Court of Federal Claims ruled February 14th that it will not reconsider its decision refusing to allow the IRS to raise offset and equitable recoupment claims which it attempted to raise after the court had already determined the IRS owes the taxpayer a tax refund. The court explained that the IRS cannot raise the claims in such an untimely manner, and that they had ample opportunity to raise such claims earlier in the proceedings.

8. Supreme Court Denies Review of *Coltec*, *Dow*, and Other Tax-Related Cases

On February 16th, the Supreme Court denied certiorari in eight tax-related cases, including the Dow Chemical and Coltec Industries cases that deal with the economic substance doctrine. In Dow Chemical Co. v. United States, the decision not to review means that the Sixth Circuit's ruling that Dow's COLI plans did not have any practicable economic effects other than the creation of income tax losses, and thus had no economic substance, will stand. In Coltec Industries Inc. v. United States, the holding of the U.S. Court of Appeals for the Federal Circuit, which said that the economic substance doctrine should be applied to invalidate a \$378 million capital loss created by Coltec's selling of high-basis stock for a relatively low price in a contingent liability transaction, also will stand.

9. CRS Updates Report on Reserves for Catastrophic Risks

In light of new legislative proposals, the Congressional Research Service (CRS) has updated a 2005 report that details arguments for and against a proposal that would allow insurers to create tax-free reserve funds for catastrophes. The 2005 report had said that the current tax and accounting law did not permit deducting reserves for future catastrophe losses, which industry analysts maintain resulted in the industry being discouraged from accumulating assets for potential catastrophes because their pre-tax ability to do so was limited. The updated report compares a tax deduction proposal set forth by the National Association of Insurance Commissioners (NAIC) and an approach specified in the Policyholder Disaster Protection Act of 2007 (H.R. 164). According to the report, the NAIC plan would make establishment of reserves mandatory and require a specific dollar target (e.g., \$40 billion over 20 years) for industry reserves. Taking a slightly different approach, H.R. 164 would permit companies to establish policyholder disaster protection funds which would consist of assets to be used solely for the payment of qualified losses. Contributions would be deductible in a particular year only to the extent there is room between a firm's cap and its fund balance; distributions from the fund would be included in gross income and subject to tax (but presumably offset by a deduction for claims paid).

10. IRS Official Discusses FIN 48 "Highly Unlikely" Standard

On February 8th, at a meeting of the District of Columbia Bar Taxation Section, Robert Adams, Senior Advisor to the Commissioner of LMSB, pointed out that the IRS has the right under I.R.C. § 7602 to re-open an examination, even though its current policy is not to re-open an examination after it has been closed. Given this, he predicted that large releases of reserves that are publicly disclosed in financial statement filings might prompt the IRS to take another look at a particular tax year and ask questions about issues they may have missed in the examination. Mr. Adams also discussed the IRS's policy not to request tax accrual workpapers and how that may or may not extend to FIN 48 workpapers. He suggested that the IRS is reconsidering whether to continue the current policy of restraint as it applies

to FIN 48 documents. The fact that public policy in general is leaning toward transparency could lead the IRS to shift its current workpaper policy as it might apply to FIN 48 workpapers. The IRS is expected to release general guidance in the next three to five months regarding how its tax accrual workpaper policy will be applied in the context of FIN 48.

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