

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

March 30, 2007

HIGHLIGHTS:

I.R.C. § 807 — IRS Releases Interest Rate Schedules for Insurance Reserve Computation

In Rev. Rul. 2007-10, 2007-10 I.R.B. 660, the IRS has supplemented the schedules of prevailing state assumed interest rates set forth in Rev. Rul. 92-19, 1992-1 C.B. 227. See Company Issues.

I.R.C. § 832 — IRS Rules Transfer by Subsidiary Reinsurer Does Not Qualify as Insurance

In PLR 200711017 (Dec. 14, 2006), the IRS National Office ruled that loss portfolio reinsurance (i.e., retroactive reinsurance) between two related reinsurance companies does not qualify as insurance for tax purposes, even though the reinsurance satisfied the criteria for risk transfer under SSAP 62 for property and casualty reinsurance and even though the state insurance department confirmed that reinsurance accounting treatment is correct. See Company Issues.

LEGISLATION

1. In General — House and Senate Add Minimum Wage/Small Business Tax Packages to the Supplemental Spending Bill

This week, both the House and Senate passed the Iraq supplemental spending bill, with the addition of their respective minimum wage/small business tax packages. As before, the Senate-passed small business tax package contains proposed changes to the tax rules for non-qualified deferred compensation, and the House-passed bill does not incorporate these changes. On the one hand, adding the minimum wage/small business tax packages to the supplemental bill may speed agreement between the House and Senate on a compromise minimum wage/small business tax package because it is attached to what might be characterized as “must pass” legislation. On the other hand, the President has stated his

intention to veto the supplemental spending bill if it comes to him with target dates for withdrawal from Iraq (which both the House and Senate bills currently have). Although some version of the House/Senate bills, with withdrawal dates, may be expected to pass in both the House and Senate, there would probably not be enough votes to override a veto.

2. Bills to Make Subpart F Active Financing Exception Permanent Introduced in House and Senate

On March 14th, Rep. Richard Neal (D-Mass) introduced H.R. 1509, which would make permanent the Subpart F deferral provision for active financial services income. An identical bill, S. 940, was introduced to the Senate on March 20th by Senate Finance Committee Chairman Max Baucus (D-Mont.) and Sen. Orrin Hatch (R-Utah). Neal said that, because this deferral is allowed for other U.S. business entities, it makes sense to allow the deferral of U.S. tax on the active business financial services income earned by foreign subsidiaries of U.S. financial services companies as well.

3. Estate Tax Amendments to the Senate Budget Resolution

On March 21st, Senator Max Baucus (D-Mont.) offered an amendment to the Senate Budget Resolution that would extend certain tax cuts targeting middle income taxpayers totaling \$180 billion in tax relief. Specifically, the amendment would provide marriage penalty tax relief, extend the refundable child tax credit, extend the adoption tax credit, extend the higher childcare tax credit, provide an earned income tax credit allowance for American soldiers' combat pay, and extend the 10 percent income tax bracket. The amendment also would freeze the estate tax at the 2009 levels — a top rate of 45% and a \$3.5 million dollar exemption — through 2012. In addition, the amendment would dedicate \$15 billion dollars to extend and expand the State Children's Health Insurance (SCHIP) program. All these provisions would be offset by the projected \$132 billion budget surplus contained in the Budget Committee-passed resolution and/or would require additional revenue offsets. The Baucus amendment to the Budget Resolution passed by a vote of 97 to 1.

POLICYHOLDER ISSUES

1. I.R.C. § 72 — Pension Annuity Benefits Allocable to a Foreign Employer's Contributions Are Taxable

In PLR 200711022 (Dec. 21, 2006), the IRS ruled that annuity benefits are entirely includable in the gross income of a U.S. citizen working abroad for a foreign employer, except for that portion of each payment which represents the return of employee contributions (i.e., investment in the contract), whether such amounts were distributed as a lump sum or as annuity payments. During the taxpayer's employment, the taxpayer had made contributions, which were includable in income for tax purposes, to the pension fund, and the taxpayer's employer made contributions of twice as much. The IRS stated that pension payments are generally taxable except to the extent they represent a return of investment in the contract under I.R.C. § 72. The foreign employer's contributions to the pension plan would be part of the investment in the contract if the amounts would have been excludable from income if they had been paid directly to the taxpayer. However, because the employer's contributions were for the taxpayer's services

after 1962, the contribution amounts all would have been includable in gross income if received directly by the taxpayer. Therefore, only the taxpayer-employee's contributions to the pension plan contract can be taken into account in determining the portion of the benefits not includable in the taxpayer's income. The IRS concluded that the exception for investment return allowed under I.R.C. § 72(d) applies to the lump sum IRA payment as well.

2. I.R.C. § 105 — Contributions to and Distributions from a Trust for Retiree Health Benefits Are Excludable from Beneficiaries' Income

In PLR 200708006 (Nov. 17, 2006), the IRS ruled that employer contributions paid to the trust and payments made from the trust which are used exclusively to pay for eligible medical care expenses of retired employees, their spouses and dependents are excludable from the gross income of retired employees, retired employees' spouses, and dependents under I.R.C. §§ 105 and 106. The ruling reached this conclusion even though some of the employer contributions on behalf of all participating employees represented all or a portion of employees' accumulated and unused vacation and sick leave upon retirement which otherwise might have been paid out, because the employer would have the sole discretion to decide the amounts that would be paid out to the employees or paid into the trust (and under no circumstances would the employees be permitted to decide the discretionary employer contributions or the percentage of vacation or sick leave to be contributed to the trust). The ruling relies on two prior IRS publications (Rev. Rul. 2005-24, 2005-1 C.B. 892, and Rev. Rul. 75-539, 1975-2 C.B. 45) in reaching its conclusion.

3. I.R.C. §§ 264 and 1035 — Exchange of Insurance Contracts Is Not a Taxable Event

In PLR 200711014 (Mar. 12, 2007), the IRS ruled that a taxpayer/life insurance company that is the owner and beneficiary of a number of life insurance contracts on its employees, officers, or directors may exchange the contracts tax free for new contracts on the lives of the same insureds and for the same face amount, assuming that the taxpayer receives no consideration for the exchanges and the insureds are employees of the taxpayer at the time of the exchange. The exchange of the old contracts for new ones with identical insureds and death benefits will qualify as a tax-free exchange under I.R.C. § 1035, and no gain or loss will be recognized on the exchange. In addition, the IRS ruled that I.R.C. § 264(f), which states that no deduction is allowed for the portion of a taxpayer's interest expense allocable to unborrowed policy cash values, does not apply to the taxpayer because I.R.C. § 264(f)(8)(B) provides that the provision does not apply to an insurance company taxable under subchapter L.

4. I.R.C. § 6050V — IRS Seeks Comments on Draft Forms for Charities with Structured Insurance Contracts, Information Reporting Requirements

The IRS issued Notice 2007-24, 2007-12 I.R.B. 750, asking for public comments on new information reporting requirements for charities that engage in structured insurance contracts, and on the congressionally mandated study of whether it is appropriate for charities to acquire such contracts. In general, section 1211 of the Pension Protection Act of 2006 (Pub. L. 109-280) imposes new information reporting requirements under I.R.C. § 6050V on organizations (including certain government entities) to which contributions are deductible for Federal income, estate or gift tax purposes ("Specified Exempt Organization"), and which acquire an interest, together with another person, in a life insurance, annuity

or endowment contract (“Applicable Contract”) in an acquisition after August 17, 2006, but on or before August 17, 2008 (“Reportable Acquisition”) and requires the Treasury to study whether such acquisitions by such organizations are consistent with their charitable purposes (with an eye toward their improper use as tax shelters).

Under these arrangements that have been classified as Reportable Acquisitions, both an exempt organization and private investors have an interest in the contract. Generally, the exempt organization has an insurable interest in the insured individuals, either because they are donors, because they consent, or because of applicable State insurable interest rules. While private investors provide capital used to fund the purchase of the life insurance contracts, (sometimes together with annuity contracts), both the private investors and the charity have an interest in the contracts, directly or indirectly, through the use of trusts, partnerships, or other arrangements for sharing the rights to the contracts. Both the charity and the private investors receive cash amounts in connection with the investment in the contracts while the life insurance is in force or as the insured individuals die.

In accordance with section 6050V, the IRS has issued draft Forms 8921 and 8922. Form 8921 will be used to report information to the IRS about structured transactions under which there have been Reportable Acquisitions of Applicable Contracts made by a Specified Exempt Organization. Form 8922 will be used to report information to the IRS about the Applicable Contracts that are part of a structured transaction required to be reported on a Form 8921. Comments on draft Forms 8921 and 8922 must be received by March 16, 2007. Comments relating to the congressionally mandated study should be received by August 22, 2007.

5. Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements

At its March 15th meeting, the Emerging Issues Task Force Unit (EITF) of the FASB concluded that a liability should be recognized when a post-retirement benefit obligation exists in a collateral assignment arrangement. The EITF had issued a draft abstract EITF Issue No. 06-10, Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements, requesting comments. The EITF received three comment letters on the issue, which all disagreed with the tentative conclusions reached at the task force’s prior discussions. The EITF modified its position, concluding that the liability (for the post-retirement benefit associated with a collateral assignment split dollar life insurance arrangement) should be recognized in accordance with either FASB Statement No. 106, Employers’ Accounting for Postretirement Benefits Other Than Pensions), of APB Opinion No. 12, Omnibus Opinion – 1967, if the employer maintains a life insurance policy during the employee’s retirement or provides the employee with a death benefit based on a substantive arrangement with the employee. Further, the EITF said that the employer should recognize the asset in a collateral assignment arrangement in a manner consistent with the terms of the assignment since there are contractual variations among collateral assignment arrangements.

COMPANY ISSUES

1. I.R.C. § 807 — IRS Releases Interest Rate Schedules for Insurance Reserve Computation

In Rev. Rul. 2007-10, 2007-10 I.R.B. 660, the IRS has supplemented the schedules of prevailing state assumed interest rates set forth in Rev. Rul. 92-19, 1992-1 C.B. 227. These rates become relevant for the computation of reserves for life insurance, accident and health, and annuity contracts because I.R.C. § 807(d)(2)(B) requires that the interest rate used to compute such reserves be the higher of the applicable federal interest rate or the prevailing state assumed interest rate.

2. I.R.C. § 832 — IRS Rules Transfer by Subsidiary Reinsurer Does Not Qualify as Insurance

In PLR 200711017 (Dec. 14, 2006), the IRS National Office ruled that loss portfolio reinsurance (i.e., retroactive reinsurance) between two related reinsurance companies does not qualify as insurance for tax purposes, even though the reinsurance satisfied the criteria for risk transfer under SSAP 62 for property and casualty reinsurance and even though the state insurance department confirmed that reinsurance accounting treatment is correct. Because the agreement between the companies covered only loss reserves, the ruling noted that “the element of fortuity is absent” and concluded that the agreement transfers only a timing and investment risk. Noting that the taxpayer could not procure an arrangement with similar terms in the commercial reinsurance market because, in part, if the companies were unrelated, the same statutory accounting treatment would not be available, the ruling also concluded that the reinsurance agreement is not insurance in the commonly accepted sense “as envisioned by the caselaw.”

3. I.R.C. § 1503(d) — IRS Released Final Rules on Dual Consolidated Losses

On March 16th, the IRS released final rules (T.D. 9315) on dual consolidated losses that drop significant restrictions. The rules are designed to prevent companies with tax residency in two countries from using the same loss to get benefits under both jurisdictions. The final regulations expand the combination rule to apply to same-country separate units of multiple domestic corporations that are members of the same consolidated group. The IRS dropped the special basis adjustment rules that override the normal investment adjustment rules in order to keep taxpayers from indirectly deducting dual consolidated losses. The new rules allow taxpayers to drop the special basis adjustment rules retroactively for all taxable years if such adjustments affected tax basis that is relevant in an open taxable year. In addition to several other provisions, the new rules promise guidance cracking down on abuses by foreign insurance companies. The final rules generally apply to dual consolidated losses incurred in taxable years beginning on or after April 18, 2007.

4. I.R.C. § 7704 — IRS Rules RIC is not Publicly Traded Partnership

In six virtually identical private letter rulings (PLRs 200711008, 200711009, 200711011, 200711012, 200711013, and 200711016), the IRS ruled that, after a regulated investment company (RIC) elects to be treated as a partnership, with a life insurance company and its subsidiary as members, it will not be a publicly traded partnership where shares are not traded on established securities markets and are not readily tradable on the secondary market. The ruling relies on I.R.C. § 7704(b), which states that the term “publicly traded partnership” means any partnership if (1) interests in such partnership are traded on an established securities market and (2) interests in such partnership are readily tradable on a secondary market. Because the interests in this partnership do not meet the requirements of a “publicly traded partnership” under I.R.C. § 7704, the IRS ruled that it will not be classified as one for tax purposes. Because the RICs will not be publicly traded partnerships, they will be eligible to check the box to be taxed as partnerships.

5. IRS Proposes Program to Solicit Input on Guidance Projects

In Notice 2007-17, 2007-12 I.R.B. 748, the IRS and Treasury announced that they plan to launch a pilot program to solicit greater public input in the initial development of some types of guidance projects. Under this program, the IRS and Treasury would publish a notice for each guidance project selected for the program that would identify required research, background documents, drafts of proposed guidance, and other work products, and ask interested parties to provide them. The purpose of the program, as explained in the notice, is to increase public participation in the preliminary stages of guidance in order to “hasten the publication of a greater number of guidance projects.”

6. LMSB Issues Classification System to Provide Consistent Treatment to Unresolved Tax Issues

On March 9th, the IRS Large and Mid-Size Business Division (LMSB) announced a new approach to resolving disputed tax issues. The “industry issue focus approach” is part of the LMSB’s strategy to improve consistency in tax disputes and better utilize resources. The approach outlines a tiered classification system, placing compliance issues into three categories. Tier 1 issues are those considered to create the greatest compliance risk and includes all currently listed transactions. In addition to the listed transactions, there are an additional fourteen issues in Tier 1, including nonqualified deferred executive compensation. Tier 2 issues are similar to Tier 1 issues, but will be handled differently by IRS field personnel. Tier 3 does not currently contain any issues, but will likely be confined to single-industry issues affecting fewer taxpayers than the other two Tiers. The program is expected to result in the IRS gaining more centralized control over disputed tax issues.

7. IRS Updates Guidance Priority List and Adds New Projects for 2006-2007

On March 12th, the IRS and Treasury Department updated the 2006-2007 priority guidance plan, adding 59 projects to the 264 items already on the list. A new project of note is guidance on exchanges of annuity contracts for purposes of I.R.C. § 1035 involving insurance companies; ongoing projects coming up for release include guidance on split-dollar life insurance under I.R.C. § 409A, contributions to welfare benefit funds, and reserves for post-retirement medical and life insurance benefits under I.R.C.

§ 419A. The updated guidance plan also listed proposed rules that are awaiting final regulations. Among these are proposed and temporary rules (REG-155608-02, T.D. 9159) published Nov. 16, 2004, and intended to provide a comprehensive update on tax deferred annuity contracts purchased by I.R.C. § 501(c)(3) organizations or public schools.

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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 Scribner, Hall & Thompson, LLP, website: www.scribnerhall.com