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

May 31, 2007

***HIGHLIGHT*:**

IRS Issues Rules of Engagement for Field Agents

The IRS issued examination "rules of engagement," using a three-tiered classification system, as part of the IRS Large and Mid-Size Business Division's strategy to improve consistency in examinations, reduce audit time, and better utilize LMSB resources by developing guidance for use in the field. Tier 1 issues are those considered by the IRS to pose the greatest compliance risk, and include all listed transactions in addition to 14 other issues. Tier 2 issues include cost sharing, stock-based compensation, extraterritorial income exclusion effective date and transition rules, contractual allowance (health care accounting), nonperforming loans, and specified liability losses under I.R.C. § 172. Tier 3 issues are industry related and have been identified as issues that should be considered by LMSB teams when conducting their risk analyses. See Company Issues.

LEGISLATION

1. War Funding Bill Includes the First Tax Provisions for 2007

After a previous version was vetoed by the President, the House and Senate approved on May 24th, and President Bush signed into law on May 25th, a war funding bill that includes an increase in the minimum wage and almost $5 billion in tax incentives for small businesses offset by revenue raisers. The enacted bill also includes four pension-related provisions, which made technical corrections to the Pension Protection Act of 2006 (Pub. L. No. 109-280). The revenue offsets may be of more importance for insurance companies than the small business incentives. The revenue offsets include (1) the increase in the age of minor children whose unearned income is taxed as parents' income, (2) an extension to 36 months the period allowed to the IRS for notification of a deficiency before the IRS must stop charging interest, (3) modification of the collection due process hearing rules where delinquent trust fund employment taxes are involved, (4) a permanent extension of IRS user fees, (5) an expansion of tax return preparer penalties, and (6) a new 20-percent penalty on refund claims that are filed without any reasonable basis.

This new lack-of-reasonable-basis penalty for refund claims would apply to the amount by which the claim exceeds the amount allowed, but would not apply to any excessive amount to which other penalties apply.

2. 2008 Budget Conference Resolution Takes into Account Certain Tax Relief and an AMT Patch, but Provides No Budget Reconciliation Requirement

The House and Senate agreed on a fiscal year 2008 budget resolution (S. Con. Res. 21) that contains provisions for recognizing permanent extensions of middle-class tax cuts (such as permanent marriage penalty tax relief, extension of the refundable child tax credit, extension of the adoption tax credit, extension of the higher child care tax credit, allowance of earned income tax credit for U.S. soldiers' combat pay, extension of the 10 percent income tax bracket, and extension of the current estate tax rate and exemption level) and a one year "patch" that would keep the alternative minimum tax (AMT) from affecting more upper-middle class taxpayers. However, the resolution contains no budget reconciliation provision that protects tax legislation under the resolution from amendment. Also, enactment of any of the tax provisions mentioned in the budget resolution would have to be subject to pay-go rules. The requirements of pay-go and lack of budget reconciliation provisions will make any substantive tax legislation in 2007 difficult, even recognizing that certain "extender provisions" will come due at the end of 2007.

3. Whether and How There Is Tax Legislation in 2007 Remains Unanswered, but Suggestions of "What" Abound

On May 8th, House Ways and Means Committee members introduced H.R. 2205, the Retirement Security for Life Act, designed to encourage retirees to select life annuities for their retirement by giving them tax incentives to do so; half of the annuity income so generated, up to $20,000 annually, would be excluded from federal income tax. The House bill was introduced as a companion to S. 1010, introduced on March 28th.

On May 10th, members of the Senate Finance Committee introduced S. 1366, which would allow life and non-life insurance companies to consolidate income and losses fully on one tax return. The bill would eliminate the current law's requirement that companies be affiliated with the same group for at least five years in order to consolidate their returns, as well as the 35-percent limit on the use of the nonlife affiliate's losses. Companion legislation (H.R. 1810) was introduced in the House on March 29th.

Also, in early May, House Ways and Means Chairman Charles Rangel (D-NY) said that he planned to offer legislation aimed at overhauling the alternative minimum tax (AMT) toward the end of June, while Republicans may offer their own alternative. Because the pay-as-you-go budgeting rules will apply to any AMT package considered by the House, Democrats are expected to propose to repeal the tax for couples earning less than $250,000 annually and individuals earning less than $125,000; to reduce AMT liability for taxpayers earning between $250,000 and $500,000 and expand the earned income and child tax credits; and to pay for all these expanded tax benefits through an increased tax liability for taxpayers earning above $500,000.

Finally, as part of an ongoing review of tax gap issues, some legislators are taking a hard look at the current treatment of fees earned in connection with hedge funds, specifically whether fund managers should pay ordinary income taxes on earnings associated with fund management, rather than capital gains taxes, because the management fee has been structured as a hedge fund investment and a partnership allocation. Although legislators and Hill staff might be described as still in the learning stage, changes in the tax rules for hedge fund management fees are likely to be considered as a possible way to increase revenue to pay for middle class tax relief from the AMT and to expand other low-income tax benefits.

POLICYHOLDER ISSUES

1. I.R.C. § 72 — Division of IRA per Divorce Settlement Is Non-Taxable Transfer

In P.L.R. 200717026 (Feb. 1, 2007), the IRS ruled that the distribution from an IRA holder's account to a former spouse as part of a divorce proceeding qualifies as a non-taxable transfer. In the facts of the ruling, the owner of an IRA is an individual under the age of 59 ½, and began taking periodic payments from the account at age 53. As part of a divorce settlement, 50 percent of the payments will be given to the taxpayer's former spouse. This division of the IRA and transfer to the former spouse will be considered a nontaxable transfer under I.R.C. § 408(d)(6). Additionally, the IRS ruled that the resulting reduced payments to the taxpayer will not constitute a modification to a series of substantially equal periodic payments under I.R.C. § 72, and so the 10-percent additional tax will not be imposed.

2. I.R.C. § 72 — Group Annuity Contract Continues to Qualify as Annuity Contract Even After Modifications

In P.L.R. 200720004 (Feb. 12, 2007), the IRS ruled that a group annuity contract that was modified to include a separate account investment option and to change contractual provisions (e.g., re the timing of expense payments and consent rules) and has twice as many certificate holders, but otherwise is substantially similar to the contract that the IRS previously ruled to qualify as an annuity contract for purposes of I.R.C. § 72, also so qualifies. In 2000, the taxpayer received a letter ruling that a group annuity contract qualified for I.R.C. § 72 treatment and was held for a natural person within the meaning of I.R.C. § 72(u). Despite the fact that the modifications could be viewed as resulting in a new group annuity contract, it was represented that the new contract was substantially the same as the contract considered in 2000. Referring to Rev. Rul. 2005-40, 2005-2 C.B. 4, which says that the risk distribution required for an arrangement to constitute insurance for federal tax purposes is absent if risks are not distributed among other insureds or policyholders, the IRS concluded that the group annuity continued to qualify as an annuity under I.R.C. § 72 and for purposes of subchapter L.

3. I.R.C. § 1035 — Check Endorsement to Second Company Not Sufficient for a Tax-Free Exchange

In Rev. Rul. 2007-24, 2007-21 I.R.B. 1282 (May 2, 2007), the IRS ruled that, if an individual receives a check from a nonqualified annuity contract and then endorses the check to a second company in exchange for a second annuity contract, the transaction does not qualify as a tax-free exchange for purposes of I.R.C. § 1035. I.R.C. § 1035(a)(3) provides that no gain or loss is recognized on the exchange of one annuity contract for another, so long as the contracts exchanged relate to the same

insured and the obligee under the contract received is the same as that under the original contract. In this circumstance, however, there was no actual exchange of annuity contracts (i.e., an assignment of the original contract to the issuer of the new contract and then a direct transfer of the cash value of the old contract to the new issuer). Because the transaction does not qualify for I.R.C. § 1035 exemption, the amount of the check received under the first contract is taxable to the individual under I.R.C. § 72(e).

COMPANY ISSUES

1. I.R.C. §§ 162 and 262 — IRS Issues Interim Guidance on Deductibility of Lodging Expenses

In Notice 2007-47, 2007-24 I.R.B. ___ (May 23, 2007), the IRS announced that it intends to amend Treas. Reg. § 1.262-1(b)(5) to provide that the costs of a taxpayer's lodging not incurred in traveling away from home are personal expenses and are not deductible unless they otherwise qualify deductible trade or business expenses under I.R.C. § 162 or deductible moving expenses under I.R.C. § 217. The Notice says that, pending the issuance of additional published guidance, the IRS will not apply current Treas. Reg. § 1.262-1(b)(5) to expenses for lodging of an employee not incurred while the employee is traveling away from home that an employer provides to the employee, or requires the employee to obtain, under the following conditions: (1) the lodging is on a temporary basis; (2) the lodging is necessary for the employee to participate in or be available for a bona fide business meeting or function of the employer; and (3) the expenses are otherwise deductible if paid by the employee, under I.R.C. § 162(a).

2. I.R.C. § 172 — IRS Denies Favorable Tax Treatment for "Exit Strategy" for Cleaning up Polluted Sites

In FAA 20071801F (Mar. 27, 2007), an IRS legal memo denies favorable tax treatment for an "exit strategy" used by major corporations to rid themselves of liability for heavily-polluted sites and to clean them up to the government's satisfaction. The strategy involves transferring the cleanup liability to another entity and purchasing what is called "insurance" to pay for the cleanup. In the memo, the IRS says that the exit strategy is in the nature of a prepaid services contact, and that only a portion of the cost is currently deductible and eligible for the specified liability loss (SLL) treatment under I.R.C. § 172(f).

3. I.R.C. § 475 — Taxpayer May Identify Qualifying Derivatives as Hedges

In P.L.R. 200717017 (Jan. 26, 2007), the IRS ruled that a taxpayer who enters into derivative transactions to manage the risk of interest rate changes associated with the issuance of debt instruments to finance mortgage asset acquisitions may identify qualifying derivatives as hedges. Prior to a specific date, the taxpayer identified each derivative on the day it was entered into as a hedge of particular debt instruments or anticipated debt issuances. In the taxpayer's books, taxpayer included a statement identifying all derivative transactions (which include interest rate swaps, basis swaps, forward starting swaps, caps, swaptions, and currency derivatives) as hedges for tax purposes. The IRS ruled that the specific identification of hedges prior to the specified date does not preclude taxpayer from identifying qualifying derivatives entered into, on or after that date as hedges of aggregate interest rate risks. Therefore, the identification statement placed in the taxpayer's books will be treated as satisfying the

identification requirements of I.R.C. § 1221, and the taxpayer is not precluded by the use of the term "liability" in I.R.C. § 475(b)(1)(C)(ii) from identifying as exempt under I.R.C. § 475(b)(2) otherwise qualifying hedges of "liabilities" that are not securities in the hands of the taxpayer.

4. IRS Seeks Comments on 2007-2008 Guidance Priority List

In Notice 2007-41, 2007-21 I.R.B. 1287 (Apr. 27, 2007), the IRS invites public comment on recommendations for items to be included on the 2007-2008 Guidance Priority List. Though suggestions for guidance may be submitted at any time during the year, in order to be considered for inclusion in the initial 2007-2008 list, submissions must be received by May 31, 2007. Submissions received after this date will be reviewed for inclusion in the next periodic update.

5. IRS Issues Rules of Engagement for Field Agents

On April 30th, the IRS issued examination "rules of engagement" as part of the IRS Large and Mid-Size Business Division's strategy to improve consistency in examinations, reduce audit time, and better utilize LMSB resources by developing guidance for use in the field. The rules, which have been added as a section in the Internal Revenue Manual, outline a three-tiered classification system. Tier 1 issues are those considered by the IRS to pose the greatest compliance risk, and include all listed transactions in addition to 14 other issues. Under the new rules, field agents will have no discretion in applying guidance to a taxpayer's facts and circumstances for Tier 1 issues. Tier 2 issues include cost sharing, stock-based compensation, extraterritorial income exclusion effective date and transition rules, contractual allowance (health care accounting), nonperforming loans, and specified liability losses under I.R.C. § 172. Tier 3 issues are industry related and have been identified as issues that should be considered by LMSB teams when conducting their risk analyses. No Tier 3 issues have been identified formally, but one might note that the recent coordinated efforts regarding the computation of the dividends-received deduction for life insurance companies seems to fit the described issue profile for Tier 3.

6. FASB Clarifies "Settlement" for Purposes of FIN 48

On May 2nd, the Financial Accounting Standards Board (FASB) issued staff guidance which clarifies the meaning of the term "settlement" in FASB Interpretation No. 48 (FIN 48). The new FASB staff position (FSP No. FIN 48-1 or FSP) should ease companies' and auditors' concerns in gauging when tax positions can be reported in financial statements. Under paragraph 10(b) of FIN 48, an entity must record the tax position's benefit when the position is "effectively settled." Prior to the issuance of the FSP, that paragraph stated that, if the more-likely-than-not recognition threshold is not met in the period for which a tax position is taken or expected to be taken, the company should recognize the benefit of the tax position in the first interim period that meets any of the following three conditions: (a) the more-likely-than-not recognition threshold is met by the reporting date; (b) the tax matter is ultimately settled through negotiation or litigation; or (c) the statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired. The FSP provides that, wherever used to describe recognition in FIN 48, the term "ultimately settled" is replaced with "effectively settled."

Also, wherever the terms "ultimate settlement" or "ultimately settled" are used to describe measurement in FIN 48, those terms are replaced with "settlement" or "settled". FSP No. FIN 48-1 is available at http://www.fasb.org/fasb_staff_positions/fsp_fin48-1.pdf.

7. IRS Posts 2001 Paper on Insurance Reserves

On May 24th, the IRS posted to its website a 2001 coordinated issue settlement position guide on examinations of I.R.C. § 807 adjustments to basis. The guide discusses under what circumstances such changes can be considered a change in basis or a correction of error. The document is available at: http://www.irs.gov/pub/irs-utl/life_insurance_-_irc_807_basis_adjustment.pdf.

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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