

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

June 29, 2007

HIGHLIGHTS:

I.R.C. § 72 — Exchange of MEC Contracts Does Not Require Further Aggregation

In Rev. Rul. 2007-38, 2007-25 I.R.B. 1420, the IRS ruled that, if a taxpayer that owns multiple modified endowment contracts (MECs) issued by the same insurance company in the same calendar year exchanges some of those MECs for new ones issued by a second insurance company, the new contracts are not required to be aggregated with the remaining original contracts. *See* Policyholder Issues.

I.R.C. § 832 — IRS Field Attorney Applies Retroactive Insurance Analysis for Directly-Written Contracts to Reinsurance Transactions

In FAA 20072502F (May 8, 2007), the IRS Associate Industry Counsel Property and Casualty Insurance (Large & Mid-Size Business) advised that loss portfolio reinsurance between a direct writer and an unrelated reinsurance company does not qualify as insurance for tax purposes because the risks transferred (i.e., the losses incurred to date) were not insurance risks under the retroactive insurance analysis of Rev. Rul. 89-96, 1989-2 C.B. 114. *See* Company Issues.

LEGISLATION

In General

Both the House and Senate tax-writers have been considering how to solve the AMT “problem.” While the House Ways and Means Committee has been considering how to implement a permanent reform, the Senate Finance Committee has been looking at a one year patch; both have to consider how to pay for the reform/patch. In the context of potential revenue raising provisions, both the House and Senate have been reviewing the tax treatment of publicly traded partnerships, specifically those partnerships that directly or indirectly derive income from investment adviser or asset management services. Under legislation (S. 1624) introduced by Finance Committee Chair Max Baucus (D-Mont.)

and ranking member Chuck Grassley (R-Iowa), such publicly traded partnerships would be taxed as corporations. Under current law, such partnerships are exempt from corporate taxation if at least 90 percent of their income is passive. According to the bill's sponsors, it is possible for partnerships to avoid taxation by structuring investment vehicles to make it appear that income is passive when it is, in fact, produced by actively providing financial services.

Although the Senate Finance Committee introduced an energy tax title, it was not part of the energy package passed by the Senate. The provisions of the energy tax title could come again, independently, but no one is suggesting exactly when that may happen. In the meantime, the Senate Finance Committee is expected to proceed with its education tax package, with the hope that the full Senate will pass something on education in July.

POLICYHOLDER ISSUES

1. I.R.C. § 72 — Exchange of MEC Contracts Does Not Require Further Aggregation

In Rev. Rul. 2007-38, 2007-25 I.R.B. 1420, the IRS ruled that if a taxpayer that owns multiple modified endowment contracts (MECs) issued by the same insurance company in the same calendar year exchanges some of those MECs for new ones issued by a second insurance company, the new contracts are not required to be aggregated with the remaining original contracts. In the facts of the ruling, an insurance company issued MECs to the taxpayer which covered the lives of the taxpayer's employees, officers and directors. The contracts were treated properly as a single MEC under I.R.C. § 72(e)(11) (redesignated as I.R.C. § 72(e)(12) by Pub. L. No. 109-208). Three years from the original purchase date, the taxpayer exchanged, without receiving any consideration, some of the original MECs for new MECs issued by a different life insurance company in an I.R.C. § 1035 exchange. The ruling concludes that the new MECs are treated as a single MEC under I.R.C. § 72(e)(12). However, the remaining original MECs and the new MECs are not aggregated with each other because they were not issued to the taxpayer in the same year by the same insurance company. The IRS noted that the same result would occur if, instead of individually issued MECs, the original and new contracts were evidenced by certificates issued under a group or master contract that were treated as separate under I.R.C. §§ 807(h), 7702 and 7702A.

COMPANY ISSUES

1. I.R.C. § 162 — LMSB Issues Guidance on Deductibility of Government Agency Settlements

At the end of May, the Large and Mid-Size Business Division (LMSB) of the IRS issued a directive (LMSB-04-507-042) addressing whether a settlement between a taxpayer and a governmental agency is deductible as an ordinary and necessary business expense under I.R.C. § 162(a) or is a nondeductible penalty under I.R.C. § 162(f). The directive notes that most actions brought by a governmental agency against a violator result in settlement, and most taxpayers deduct the entire civil settlement amount. This is a "Tier 1" issue as classified by the LMSB's recently-released "rules of

engagement” for conducting examinations, indicating that it possesses a high noncompliance risk. The directive says that the examination of False Claim Act (FCA) settlements in excess of \$10 million and supplemental environmental projects (SEP) in excess of \$1 million is mandatory.

The directive outlines four basic areas of issue development designed to give the agent a step-by-step approach to be used in determining the facts and circumstances for development for the audit. With regard to the FCA issue, the current LMSB position, according to the directive, is to look to the settlement of a fraud investigation by the Department of Justice (DOJ), so that the position can only be developed through communication, coordination, and cooperation between the IRS and the DOJ. On the SEP issue, the directive states that taxpayers may not deduct the portion of the costs incurred for the performance of a SEP (i.e. the amount analogous to a nondeductible fine or similar penalty as defined in I.R.C. § 162(f)). Finally, the directive says that taxpayers may not include in the basis of assets it produces under I.R.C. § 263A, or as the basis of property under I.R.C. § 1012, the portion of the SEP costs that is an amount analogous to a fine or similar penalty.

2. I.R.C. § 172 — Court Rules Retrospective Adjustments to Premiums and Administrative Expenses May Be Classified as Losses

In *Harvard Secured Creditors Liquidation Trust v. IRS* (Doc. No. 3:07-cv-00305, D. N.J., June 4, 2007), a district court held that the retrospective adjustments a company paid on its workers’ compensation and general liability policies, as well as administrative expenses, are deductible losses. In the facts of the case, Harvard Industries, Inc. (Harvard) filed for Chapter 11 bankruptcy in January 2002. In 2003, Harvard sought a refund based on different types of expenses, including payments for workers compensation insurance policies. The Bankruptcy Court granted the refund request for certain expenses, but denied the request as to the workers compensation expenses. After appeal and remand, the Bankruptcy Court ruled that Harvard was allowed to carry back the payments that is made for certain adjustments to its retrospective workers compensation insurance policies, but not the administrative expenses it was charged by its insurer, Wausau Insurance Company (Wausau), with respect to those policies. The District Court of New Jersey, reasoning that the administrative expenses paid by Harvard to Wausau are part of the price that Harvard agreed to pay for the workers compensation insurance, because they were calculated based on Harvard’s expected or actual losses, determined that administrative fees should not be treated differently from insurance premiums. As the payment of those charges “constitute payments ‘aris[ing] out of the provision to the taxpayer of insurance’” as outlined in Treas. Reg. § 1.461-4, the court held that Harvard is entitled to deduct the administrative costs in addition to the premiums paid. The court further held that Harvard was entitled to offset deductions for carryback losses by the amount allocable to a member of its consolidated group that it had filed a consolidated return with in a later year.

3. I.R.C. § 274 — Proposed Regulations Issued on Deductions for Entertainment Use of Business Aircraft

The IRS has issued proposed regulations (REG-147171-05) on the tax treatment of the entertainment use of business aircraft to reflect amendments made by the American Jobs Creation Act of 2004 and the Gulf Opportunity Zone Act of 2005. The proposed regulations incorporate interim guidance provided in Notice 2005-45, 2005-24 I.R.B. 1228. In response to suggestions that the accelerated depreciation method would result in excessive amounts disallowed in early years, the

proposed regulations allow a taxpayer to elect to calculate depreciation on a straight-line basis over the class life of the aircraft when calculating the amount of disallowed expenses. Under Notice 2005-45, an aircraft returning empty from a flight after discharging passengers or traveling empty to pick up passengers (deadheading) is treated as having the same number and character of occupied seat miles or hours as the leg or legs of the trip on which passengers are aboard. According to the preamble to the proposed regulations, commentators apparently suggested a similar safe harbor approach, however the proposed regulations do not adopt such a safe harbor. Instead, the proposed regulations provide an example of the application of the deadhead flight rule and explain application of the rule in cases where the deadhead flight occurs between two unrelated flights involving more than two destinations. Additional comments are requested to address this issue, and presumably to assist in further guidance being issued. A public hearing is scheduled for October 25, 2007. Comments are due by September 13th, and topic discussion outlines for the hearing are due by October 4th.

4. I.R.C. § 501 — IRS Rules Organization Does Not Qualify for Exempt Treatment

In P.L.R. 200724036 (Mar. 20, 2007), the IRS denied an organization I.R.C. § 501(c)(15) exempt insurance company status because its insurance arrangements did not contain adequate risk distribution and risk shifting as required for insurance tax purposes. The company stated in its business plan that it was formed to provide to its owner's spouse, possibly its owner, and other state physicians medical malpractice insurance. In 2004, taxpayer issued three one-year "insurance contracts". The contracts were issued to its owner's spouse, the owner, and the owner's spouse's employer. In 2005, taxpayer issued six one-year "insurance contracts". Three of the six contracts were renewals of the contracts issued in 2004, with the remaining three issued to provide insurance for the spouse's business office, flood insurance for the owner and the spouse, and flood insurance for an unidentified company. Basing its analysis on case law and prior revenue rulings, the IRS concluded that the arrangement offered by the taxpayer does not contain risk distribution or risk shifting, and thus does not satisfy the definition of "insurance" for federal income tax purposes. Specifically, the ruling states that the taxpayer "maintained too few risks with only six 'insureds.'" These insured risks were not homogenous, which further diluted the distribution within the small number of insureds." The IRS further noted that "[taxpayer]'s number of insured risks remained relatively low As such, adequate risk distribution was not present as [taxpayer] combined too few insureds with too few risks insured." Finding that the arrangement were not insurance because there was insufficient risk distribution, the IRS denied I.R.C. § 501(c)(15) tax-exempt status to the taxpayer.

5. I.R.C. § 831 — IRS Consents to Taxpayer's Revocation of Election

In P.L.R. 200724024 (Mar. 15, 2007), the IRS consented to a taxpayer's request to revoke its election under I.R.C. § 831(b)(2)(A)(ii) to be taxed in net investment income only. The taxpayer, a provider of mutual insurance, requested the revocation because it has incurred more underwriting losses in recent years than in the past, due to broader coverages without the ability to receive sufficient premiums to recover the costs of losses and expenses, increased repair costs, increased operating expenses, and an inability to increase premium charges due to competition. The IRS agreed that a revocation of the election was appropriate because the nature of the taxpayer's insurance business had changed significantly since its initial election.

6. I.R.C. § 832 — IRS Field Attorney Applies Retroactive Insurance Analysis for Directly-Written Contracts to Reinsurance Transactions

In FAA 20072502F (May 8, 2007), the IRS Associate Industry Counsel Property and Casualty Insurance (Large & Mid-Size Business) advised that loss portfolio reinsurance between a direct writer and an unrelated reinsurance company does not qualify as insurance for tax purposes because the risks transferred (i.e., the losses incurred to date) were not insurance risks under the retroactive insurance analysis of Rev. Rul. 89-96, 1989-2 C.B. 114. The FAA fails to note any distinction between the reinsurance transaction addressed therein and the directly-written contract considered in Rev. Rul. 89-96, where the purchaser of the contract was attempting to gain a new premium deduction for “insurance” of an event after the event and loss to the policyholder has occurred. Setting forth and applying what seems to be a new test for risk transfer for reinsurance, the FAA uses tax effects of the transaction for the assuming company as a factor to determine whether risk has been transferred. In so doing, it fails to address the fact that the risks transferred by the reinsurance are valid insurance risks on the books of the direct writer, that the nature of those risks is not changed when assumed by the reinsurer, and that a new tax benefit is not created solely by the reinsurance transaction.

7. I.R.C. § 847 — IRS Field Attorney Concludes that Special Estimated Tax Payments Should Not Be Refunded

In FAA 20072501F (May 10, 2007), the IRS Associate Industry Counsel Property and Casualty Insurance (Large & Mid-Size Business) advised that special estimated tax payments (SETP), which had been applied to pay tax pursuant to I.R.C. § 847, should not be refunded when the need to apply the SETP was eliminated by the application of a net operating loss carryback. The FAA indicates that the displaced SETP amount should be treated again as SETP available for future additions to tax under I.R.C. § 847 and as available for refund only in the sixteenth year after the SETP was first made. The FAA notes that its position is in disagreement with Appeals.

8. I.R.C. §§ 864 and 904 — IRS Seeks Comments on Definitions of Financial Services Income, Active Financing Income and Financial Services Entities

In Notice 2007-58 (June 26, 2007), the IRS is requesting comments on the definitions of financial services income, active financing income and financial services entities under Treas. Reg. § 1.904-4(e). The definitions need to be revised in light of the reduction in the number of baskets under I.R.C. § 904(d) and the modifications to the interest expense allocation rules of I.R.C. § 864 made by the American Jobs Creations Act of 2004. In a related Announcement 2007-62, the IRS asks for comments on the revised Form 1118, which is filed by some corporations claiming the foreign tax credit. Comments under Notice 2007-58 or Announcement 2007-62 should be submitted to the IRS by September 10, 2007.

9. I.R.C. § 4980G — IRS Proposes Regulations on HSA Employer Contributions

At the end of May, the IRS released proposed regulations (REG-143797-06) that provide guidance on employer comparable contributions to Health Savings Accounts (HSAs) under I.R.C. § 4980G where the employee has not established an HSA by December 31st and where an employer accelerates contributions for the calendar year for employees that have incurred qualified medical

expenses. The proposed regulations provide that, in instances where an employee has not established an HSA by December 31st (or where the employee has established the HSA but has not notified the employer), the employer must comply with a notice and a contribution requirement by providing such employees written notice by January 15th of the following year that such eligible employees will receive a comparable contribution to the HSA. Further, the employer must contribute to the HSA by April 15th comparable amounts plus reasonable interest. In addition, the proposed regulations also provide that an employer may accelerate part or all of its contributions for the entire year to the HSAs of employees who have incurred qualified medical expenses exceeding the employer's cumulative HSA contributions. If the employer accelerates contributions for this reason, the contributions must be available equally to all eligible employees. A public hearing has been scheduled for September 27, 2007 on the proposed rules, and the IRS has requested outlines of topics to be discussed by August 28th. Written or electronic comments on the proposed regulations are due August 30th.

10. I.R.C. § 6694 — Transitional Relief Provided to Return Preparers

In Notice 2007-54, 2007-27 I.R.B. 1, the IRS provided guidance and transitional relief for the return preparer penalty provisions as amended by the Small Business and Work Opportunity Act of 2007 (Pub. L. No. 110-28). The 2007 Act amendments to I.R.C. § 6694 and related provisions (i) broadened the positions to which the penalty is applicable from those for which there was “not a *realistic possibility* of being sustained on its merits” to those for which there was “not a *reasonable belief that the position would more likely than not* be sustained on its merits;” (ii) limited the avoidance of the penalty by disclosure to positions meeting a reasonable basis standard (where under prior law disclosure could avoid the penalty as long as the position taken was not frivolous); (iii) extended the scope of those persons to which the penalties apply from an “income tax return preparer” to preparers of all tax returns, amended returns and claims for refund, including estate and gift tax returns, generation-skipping transfer tax returns, employment tax returns, and excise tax returns; and (iv) increased the first-tier penalty (I.R.C. § 6694(a)) from \$250 to “the greater of \$1000 or 50 % of the income derived (or to be derived) by the tax return preparer from the preparation of a return or claim with respect to which the penalty was imposed,” and increased the second-tier penalty (I.R.C. § 6694(b)) for willful or reckless conduct from \$1000 to “the greater of \$5,000 or 50 % of the income derived (or to be derived) by the tax return preparer.” For income tax returns, amended returns, and refund claims, Notice 2007-54 provides that the standards set forth under the previous law and current regulations under I.R.C. § 6694 will be applied in determining whether the IRS will impose a first-tier penalty under I.R.C. § 6694(a). No transitional relief was provided with respect to second-tier penalties (I.R.C. § 6694(b)) relating to return preparers who exhibit willful or reckless conduct. The transitional relief applies to all returns, amended returns, and refund claims due on or before December 31, 2007; to 2007 estimated tax returns due on or before January 15, 2008; and to 2007 employment and excise tax returns due on or before January 31, 2008.

11. FIN 48 Documentation Considered Tax Accrual Workpapers

In generic legal advice (A.M. 2007-0012, Mar. 22, 2007), the IRS concluded that documents produced by a taxpayer and/or its auditors to substantiate the taxpayer's uncertain tax positions in compliance with Financial Accounting Standards Board Interpretation 48 (FIN 48) are considered tax accrual workpapers as provided in section 4.10.202(2) of the Internal Revenue Manual. The advice explains that the documentation requirements that taxpayers follow are established by the Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB) and the

American Institute of Certified Public Accountants (AICPA), and the documentation requirements established by these entities has remained unchanged by the issuance of FIN 48. Consequently, the issuance of FIN 48 does not change whether a document is considered to be a tax accrual workpaper as defined by I.R.M. 4.10.20.2(2).

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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