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TAX ISSUES SUMMARY

August 27, 2007

***HIGHLIGHTS*:**

I.R.C. § 807 — Use of the AFIR to Determine Required Interest for Variable Contracts

In Rev. Rul. 2007-54, 2007-38 I.R.B. ___, the IRS addresses the computation of required interest for variable contracts under I.R.C. § 812(b)(2)(A). The ruling concludes that, if the life insurance reserve for the aggregate benefits of a variable contract (i.e., the life insurance reserve under I.R.C. § 807(c)(1)) is computed under I.R.C. § 807(d)(2), then required interest for that contract must be computed using the interest rate prescribed for the reserve computation under I.R.C. § 807(d)(2)(B) (i.e., the higher of the applicable federal interest rate or the prevailing state assumed interest rate). *See* Company Issues.

IRS Releases 2007-2008 Priority Guidance Plan

The IRS and Treasury released the 2007-2008 Priority Guidance Plan, which contains eight items in the "Insurance Companies and Product" category. *See* Company Issues.

LEGISLATION

1. In General

Before leaving for their month-long August recess, both houses of Congress passed reauthorizations of the State Children's Health Insurance Program (SCHIP). Although both houses looked to increases in tobacco taxes as revenue for SCHIP, the bills are different enough, that for the conference to reach a single bill is expected to be difficult, and then the Administration is still expected to veto whatever is produced. A provision of interest to insurance companies that is currently part of SCHIP is the provision that would impose a new fee on most accident and health insurance policies issued for U.S. residents. This fee would be paid by the insurance company issuing the policy and would be used for a "healthcare comparative effectiveness research trust fund" under new I.R.C. § 9511.

Just before the August recess, another tax provision drawing concern was a proposal to amend the tax code to prevent multinational companies from avoiding tax payments by sending money to lower-tax countries. This provision was offered in a bill sponsored by Ways and Means Committee member Lloyd Doggett (D-Texas) but, without hearings or mark-up by the Ways and Means Committee, was added to the Farm, Nutrition, and Bioenergy Act of 2007 to offset the $4 billion cost of additional new farm programs. House Ways and Means Committee Chairman Chuck Rangel (D-NY) expressed general concern that the committee had been asked to raise revenues for the House Agriculture Committee's farm bill reauthorization, while House Republicans generally complained that the legislative process was being abused.

2. Bills Relating to Insurance Interests Are Introduced

In early August, House Ways and Means Committee member Rep. Earl Pomeroy (D-N.D.) introduced the "Long Term Care Affordability and Security Act of 2007" (H.R. 3363), which would end restrictions on providing long term care (LTC) insurance through cafeteria plans or flexible spending arrangements. This has been a legislative agenda item for the American Council of Life Insurers (ACLI) because allowing tax-exempt treatment under employer benefit plans, likely will increase LTC insurance sales substantially. The ACLI estimates that the proposed legislation would cost around $500 million in lost tax revenues, but would be followed by future Medicaid savings as more people opt to purchase LTC insurance.

Also, Reps. Melissa Bean (D-Ill.) and Ed Royce (R-Calif.) introduced the "National Insurance Act of 2007", which would create a federal system of regulation and supervision for insurers as well as agents and brokers, similar to the dual banking system. Under the bill, insurers and producers could elect either federal or state regulation, charters, and licenses, and states would maintain responsibility for regulating state-licensed insurers and producers. The bill has the support of eleven financial institution trade groups, including the ACLI. The bill was introduced as companion legislation to a similar bill introduced in the Senate in May.

POLICYHOLDER ISSUES

1. I.R.C. § 104 — Murphy Files Petition for En Banc Review in *Murphy v. IRS*

On August 17, attorneys for Marrita Murphy filed a petition for a rehearing en banc with the U.S. Court of Appeals for the District of Columbia Circuit (*Murphy v. IRS*, D.C. Cir., Doc. No. 05-5139). Murphy's lawyers said they are requesting further review because the recent ruling on rehearing of the case by the three-judge panel (holding that I.R.C. § 104(a)(2) is constitutional and allows taxation on an individual's award of damages for emotional distress and injury to professional reputation) conflicts with decisions issued by the Supreme Court and other circuits.

2. I.R.C. § 817 — IRS Expands List of Arrangements with "Permitted-Investor" Status as Qualified Pension Plans

The IRS just released Rev. Rul. 2007-58, 2007-37 I.R.B. ___, which supplements Rev. Rul. 94-62, 1994-2 C.B. 164, by listing additional arrangements that will be treated as a "qualified pension or retirement plan" for purposes of applying Treas. Reg. § 1.817-5(f)(3)(iii) and the look-through rule to a regulated investment company (RIC), partnership or trust that is used as an investment vehicle for variable contracts. A qualified pension or retirement plan is one of the listed permitted investors that can own beneficial interests in the RIC, partnership or trust directly (i.e., not through a segregated asset account of an insurance company) and not cause the RIC, partnership or trust to fail the applicability requirements for the look-through rule for determining whether it meets I.R.C. § 817(h) diversification requirements. To the nine types of arrangements listed in Rev. Rul. 94-62 as eligible for treatment as a "qualified pension or retirement plan," Rev. Rul. 2007-58 adds five more: (1) a simple retirement account, as described in section 408(p); (2) a deemed IRA, as described in section 408(q); (3) a Roth IRA described in section 408A; (4) a section 415(m) plan that is also a "governmental plan" within the meaning of section 414(d); and (5) a section 457(f) plan that has as its sponsor either (i) a charitable organization described in section 818(a)(4), or (ii) a governmental organization described in section 818(a)(4), whose employees are described in section 403(b)(1)(A)(ii). Like Rev. Rul. 94-62, Rev. Rul. 2007-58 continues to provide that, in addition to the arrangements specifically listed therein as being eligible for treatment as a "qualified pension or retirement plan," such term also includes any trust, plan account, contract, or annuity that the IRS has determined in a letter ruling to be within the scope of Treas. Reg. § 1.817-5(f)(3)(iii).

3. Court Rules Tax-Deferred Retirement Annuity Excluded from Bankruptcy Estate

In *Skiba v. Laher*, Doc. No. 05-4168 (3d Cir. Aug. 2, 2007), the U.S. Court of Appeals for the Third Circuit ruled that a tax-deferred retirement annuity plan governed by New York law is excluded from a debtor's bankruptcy estate. The debtor argued that his annuity is treated as an express trust and therefore should be excluded from the bankruptcy estate. The bankruptcy trustee argued that the annuity should be characterized as merely a debtor-creditor relationship, and not a trust. Noting that a provision in the annuity contract states that the validity and effect of all rights and duties under it are governed by New York law, the court agreed with the debtor and ruled that the annuity plan, being an employer-mandated retirement plan, constitutes a trust that is excluded from the bankruptcy estate.

COMPANY ISSUES

1. I.R.C. § 807 — Use of the AFIR to Determine Required Interest for Variable Contracts

In Rev. Rul. 2007-54, 2007-38 I.R.B. ___, the IRS addresses the computation of required interest for variable contracts under I.R.C. § 812(b)(2)(A). The ruling concludes that, if the life insurance reserve for the aggregate benefits of a variable contract (i.e., the life insurance reserve under I.R.C. § 807(c)(1)) is computed under I.R.C. § 807(d)(2), then required interest for that contract must be computed using the interest rate prescribed for the reserve computation under I.R.C. § 807(d)(2)(B) (i.e., the higher of the

applicable federal interest rate or the prevailing state assumed interest rate). The ruling considers two issues: (1) What is the amount of the life insurance reserves taken into account under I.R.C. § 807 for a variable contract, where some or all of the reserves are accounted for as part of a company's separate account reserves? and (2) If the amount of the life insurance reserves for a variable contract is the tax reserve determined under I.R.C. § 807(d)(2), what interest rate is used to calculate required interest on those reserves?

With respect to the first issue, the ruling concludes that the allocation of obligations between general account reserves and separate account reserves has no effect on the determination of the amount of the company's life insurance reserves for the variable contract under I.R.C. § 807(d). With respect to the second issue, the ruling explains that required interest on a contract's reserves is calculated using the mean of the contract's beginning-of-year and end-of-year reserves with interest rate used in determining the contract's reserves. The ruling then concludes that, because the applicable federal interest rate was to determine the amount of the life insurance reserves for the contract in both situations, the required interest on the contract's life insurance reserves must be calculated by multiplying the mean of those reserves by the applicable federal interest rate for the contract.

2. I.R.C. §§ 6110, 6111 and 6112 — IRS Issues Final Guidance on Disclosure of Reportable Transactions and Rules for Materials Advisors

On July 31, the IRS released a package of final regulations on the disclosure of reportable tax shelter transactions and associated requirements affecting material advisors. The first set of regulations, T.D. 9350, modifies the rules on the disclosure of reportable transactions under I.R.C. § 6011. Consistent with what was proposed, the final regulations eliminate the "transactions with a significant book-tax difference" category of reportable transactions, and add "transactions of interest" as a new category of reportable transactions. Despite several commentators' suggestions that the regulations include greater specificity and guidance on the IRS' criteria for a transaction of interest, the final regulations adopt without change the language in the proposed regulations establishing the new category. In addition, the IRS extends from 45 days to 60 days, the time participants in a reportable transaction have to file a disclosure statement with the Office of Tax Shelter Analysis. The regulations also give taxpayers 90 days, rather than 60 days as specified in the proposed regulations, to disclose their participation in a listed transaction or transaction on interest that the IRS identifies as such after the filing of the taxpayer's return.

The second set of regulations, T.D. 9351, provides rules on the disclosure of reportable transactions by material advisors under I.R.C. § 6111 as amended by the American Jobs Creation Act of 2004. The final regulations adopt regulations (REG-103039-05) proposed in 2006, with some modifications. The new rules provide that, unless the facts and circumstances prove otherwise, if at least 70 percent of the tax benefits from a reportable transaction are provided to natural persons, substantially all the tax benefits will be considered to be provided to natural persons. Additionally, in response to comments received, the final regulations provide that a material advisor must provide the identities of any material advisor who the material advisor knows or has reason to know acted as a material advisor regarding the transaction.

The third set of regulations, T.D. 9352, provides rules for material advisors who must prepare and maintain lists for reportable transactions, and reflects revisions to I.R.C. §§ 6111 and 6112 as amended by the American Jobs Creation Act of 2004. The final regulations require that material advisors prepare and maintain a list (including an itemized statement, transaction description, and documents relating to the transaction) for each reportable transaction. Accepting the recommendation of commentators, the IRS removed the requirement contained in the proposed regulations that material advisors would have 20 days to make each list component available to the IRS. Several commentators suggested that the IRS should have flexibility to determine the appropriate production schedule based on information provided. The IRS explained that it removed the fixed time requirement language, but will issue future guidance addressing the issue.

All the regulations released in this package have an effective date of August 3, 2007.

3. IRS Releases 2007-2008 Priority Guidance Plan

The IRS and Treasury released the 2007-2008 Priority Guidance Plan on August 13. The Plan contains eight items in the "Insurance Companies and Product" category, specifically: (1) final regulations on the exchange of property for an annuity contract; (2) guidance concerning I.R.C. § 72(e) and partial exchanges; (3) guidance on the qualification of certain arrangements as insurance; (4) final regulation on taxable asset acquisitions and dispositions of insurance companies; (5) revenue ruling concerning the meaning of the term "statutory reserves" under I.R.C. § 807 where the company is subject to different statutory reserve requirements in different states; (6) final regulations to expand the list of holders whose beneficial interests in an investment company, partnership or trust do not prevent a segregated asset account from looking through to the assets of the investment company, partnership or trust to satisfy the requirements of I.R.C. § 817(h); (7) guidance concerning corporate-owned life insurance under section 863 of the Pension Protection Act of 2006; and (8) guidance concerning remediation procedures for life insurance and annuity contracts based on comments received in response to Notice 2007-15.

4. FASB to Draft Exposure Document Extending Reinsurance Accounting to Non-Insurance Enterprises

The Financial Accounting Standards Board (FASB) announced on July 25th that it would start drafting an exposure document that would require non-insurance enterprises to apply the risk transfer conditions of reinsurance accounting. Under the proposed guidance, FASB Statement No. 113, which provides guidance on whether risk has been transferred by a reinsurance contract, would broaden beyond reinsurance contracts, to include contracts between non-insurance enterprises policyholders and insurers. The project was initially started to address "finite contracts" that were not transferring risk but that were being accounted for as though they were, according to an FASB staff member. Aimed at improving the disclosure requirements around insurance and reinsurance contracts, the proposed guidance not only would provide more disclosure requirements around the types of contracts that have risk limiting features, but also and would expand its coverage to include policyholders and insurers.

The FASB said that the same risk transfer conditions for reinsurance contracts in Statement No. 113 should be applied to insurance contracts. The board also discussed eliminating language that leads

individuals to get to the "10/10" rule, which says that a contract should have a ten percent probability of a ten percent loss to be considered to contain adequate risk. The guidance, once released, will be effective for financial statement issues for the fiscal year beginning after December 15, 2008.

***IRS Circular 230 Disclosure*:**

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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
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