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TAX ISSUES SUMMARY

September 17, 2007

***HIGHLIGHT*:**

I.R.C. § 264(f) — IRS Creates Safe Harbor for I-COLI Contracts

In response to the insurance industry's efforts to reverse a position tentatively adopted by the IRS, that an insurance company must prorate increases in policy cash values for all insurance-company-owned life insurance contracts issued after June 8, 1997, the IRS released Rev. Proc. 2007-61, 2007-40 I.R.B. ___, which provides a safe harbor under which the IRS will not require the application of proration to increases in policy cash values for insurance-company-owned life insurance contracts. Specifically, under the revenue procedure, an insurance company is not required to take into account any portion of the increase for the taxable year in the policy cash values of life insurance contracts "covering no more than 35% of the total aggregate number of individuals described in I.R.C. §264 (f)(4)(A) [generally, 20% owners, officers, directors and employees] at any time during the taxable year." *See* Company Issues.

I.R.C. §§ 807(d) and 812 — Rev. Rul. 2007-54 Formally Published

Rev. Rul. 2007-54, which concludes that a single reserve for a variable contract computed under the Federally prescribed rules of I.R.C. § 807(d)(2) prescribed the interest rate to be used to calculate required interest for that variable contract under I.R.C. § 812(b)(2)(A), has been published formally in 2007-38 I.R.B. 604. *See* Company Issues.

LEGISLATION

1. In General

Both the House and Senate tax-writing committees have set a full agenda since returning from the Congressional August recess. House Ways and Means Committee Chair Charles Rangel (D-N.Y.) has said that an all-encompassing tax bill would be introduced later this year that would eliminate the alternative minimum tax (AMT) and readjust current tax rates to offset the cost; the goal would be to

transfer the tax cuts enjoyed by the few people to help close the gap between the working poor and the very wealthy. In addition, the bill would include a more liberal child tax credit, an increased earned income tax credit, and an increased standard deduction. Rangel's plan is at odds with the likely approach of the Senate Finance Committee, which favors just another temporary patch to prevent the AMT from affecting more middle-class taxpayers while lawmakers work on a more permanent solution. Along with the passage of some solution for the AMT problem, both the House and Senate are expected to extend the expiring provisions by the end of the year.

The agenda for the Senate Finance Committee also seems to include several separate tax bills. Chairman Max Baucus (D-Mont.) announced his intention to work on an education tax bill that would expand college tuition tax credits, extend the expiring deductions for student-loan interest payments and for teachers' payments from their own funds to purchase classroom supplies, and create tax incentives to encourage investment in I.R.C. § 529 college savings plans. At the same time, Chairman Baucus has also indicated that the Senate Finance Committee would work on a tax portion to be included in the Senate's "farm bill," but unlike the House's bill, any tax revenue raised by the bill would only offset tax benefits designed to help farmers.

Both the House and Senate tax-writing committees are expected to consider tax provisions to help alleviate the foreclosure crisis for sub-prime mortgages. Legislation introduced in the House (H.R. 1876, introduced in April) and in the Senate (S. 1394, in May) would make any mortgage debt forgiven by lenders, when individuals lose their home to foreclosure, non-taxable. Also on the financial front, and perhaps growing out of the tax-writing committees' focus on hedge funds and carried interest issues, legislation has been introduced in the House that would allow tax-exempt entities to invest in on-shore hedge funds without using a foreign entity "UBIT blocker." Under the proposed legislation introduced by Congressman Sander Levin (D-Mich.), I.R.C. § 514(c) would be amended to provide that, if a partnership incurs debt to buy securities and commodities, that debt will not be treated as "acquisition indebtedness" by exempt organizations that are limited partners in that partnership for unrelated business income tax (UBIT) purposes. If the Senate considers something comparable, the exception from "acquisition indebtedness" also may include requirements for the tax-exempt entity using it for exempt purposes.

2. I.R.C. § 831(b) — Bill Introduced to Increase the Investment Income Election Threshold for Small Insurance Companies

On September 12th, Senators Christopher Bond (R-Mo.) and Blanche Lincoln (D-Ark.) introduced S. 2040, a bill which would increase the investment income election threshold in I.R.C. § 831(b) from $1.2 million to $1.971 million, as well as provide for annual inflation adjustment to the threshold. Currently, the Code allows small property/casualty insurance companies to elect to be taxed only on investment income, if the greater of net or direct written premiums for the taxable year exceed $350,000, but do not exceed $1.2 million. This level has not been modified since it was last set in 1986. The new legislation would raise the level and allow for automatic increases periodically to account for inflation.

3. House Passes Bill Barring Tax Strategy Patents; Senate May Have Similar Legislation

On September 7th, the House approved, by a vote of 220-175, a patent reform bill (H.R. 1908) that includes a prohibition on tax strategy patents. The legislation would make any tax strategy methods "unpatentable" and would define a tax strategy patent as "a plan, strategy, technique or scheme that is designed to reduce, minimize or defer, or has, when implemented, the effect of reducing, minimizing or deferring, a taxpayer's tax liability." The patent reform bill currently being worked on in the Senate does not contain a similar provision on tax strategies, however, Senate Finance Committee Chairman Baucus and ranking-committee-member Charles Grassley (R-Iowa) are spearheading the crafting of a bill specifically designed to ban tax strategy patents.

COMPANY ISSUES

1. I.R.C. § 264(f) — IRS Creates Safe Harbor for I-COLI Contracts

In response to the insurance industry's efforts to reverse a position tentatively adopted by the IRS that an insurance company must prorate increases in policy cash values for all insurance-company-owned life insurance contracts issued after June 8, 1997, the IRS released Rev. Proc. 2007-61, 2007-40 I.R.B. ___, which provides a safe harbor under which the IRS will not require the application of proration to increases in policy cash values for insurance-company-owned life insurance contracts. Specifically, under the revenue procedure, an insurance company is not required to take into account any portion of the increase for the taxable year in the policy cash values of life insurance contracts "covering no more than 35% of the total aggregate number of individuals described in I.R.C. §264(f)(4)(A) [generally, 20% owners, officers, directors and employees] at any time during the taxable year." Although Rev. Proc. 2007-61 acknowledges arguments for both a favorable and adverse interpretation of the reference to "contracts to which section 264(f) applies" as defining the policy cash values subject to proration, it does not set forth a substantive conclusion regarding the correct interpretation of that phrase. The safe harbor is effective September 11, 2007, and, if any additional guidance is published interpreting the phrase "contracts to which section 264(f) applies," the new guidance will apply prospectively.

The revenue procedure requests comments on the need for additional guidance in the area of insurance-company-owned life insurance contracts, and also requests information on non-tax regulatory rules and other requirements that limit an insurance company's ability to invest in cash value life insurance contracts and the effect of any experience rating, inter-insurance, reciprocal, or reinsurance arrangements involving insurance-company-owned life insurance contracts. All comments are requested to be submitted by December 31, 2007.

2. I.R.C. § 409A — IRS Extends Documentation Deadline

In Notice 2007-78 (Sept. 10, 2007), the IRS announced that it will extend the deadline for documentary compliance with I.R.C. § 409A to December 31, 2008. The notice did not extend, however, the January 1, 2008 effective date of the final nonqualified deferred compensation regulations (T.D. 9321). The final regulations apply to tax years beginning after December 31, 2007, and require that the

material terms of a nonqualified deferred compensation plan be in writing. The notice states that the transition relief is limited and taxpayers may not rely on a reasonable, good faith interpretation of the statute for taxable years beginning on or after January 1, 2008, except as permitted by the final regulations.

3. I.R.C. §§ 807(d) and 812 — Rev. Rul. 2007-54 Formally Published

Rev. Rul. 2007-54 (released August 16, 2007; see a discussion of it in the Tax Issues Summary dated August 27, 2007), which concludes that a single reserve for a variable contract computed under the Federally prescribed rules of I.R.C. § 807(d)(2) prescribed the interest rate to be used to calculate required interest for that variable contract under I.R.C. § 812(b)(2)(A), has been published formally in 2007-38 I.R.B. 604.

4. I.R.C. § 842 — IRS Releases Domestic Asset/Liability Percentages for Foreign Life Insurance Companies

In Rev. Proc. 2007-58, 2007-37 I.R.B. 585, the IRS released the domestic asset/liability percentages and domestic investment yields to be used by foreign life insurance companies and foreign property and liability insurance companies to compute their minimum effectively connected net investment income under I.R.C. § 842(b) for tax years beginning after December 31, 2005.

5. I.R.C. §§ 6402 and 6411 — Overpayments May Be Credited Against Unassessed Liabilities

In Rev. Rul 2007-51, 2007-37 I.R.B. 573 (Aug. 24), the IRS ruled that it may credit an overpayment against unassessed tax liabilities that have been determined in a notice of deficiency sent to the taxpayer, under I.R.C. § 6402(a). In addition, the IRS may credit a decrease in tax resulting from a tentative carryback adjustment against those liabilities, under I.R.C. § 6411(b). I.R.C. § 6402(a) allows an overpayment to be credited against any liability in respect of an internal revenue tax payment on the part of the party that made the payment, so long as it is within the applicable period of limitations. I.R.C. § 6411(a) provides that a taxpayer may file an application for a tentative carryback adjustment of tax for the prior tax year affected by a net operating loss (NOL) carryback, business credit carryback, or capital loss carryback from any tax year. According to I.R.C. § 6411(b), an examination of the application must be made within 90 days of the application filing date to determine if there are any omissions or computation errors, as well as determine the amount of the decrease in tax attributable to the carryback. This decrease in tax will be applied first against any unpaid tax for the carryback year. Next, it will be applied to any unsatisfied amount of tax for the tax year immediately preceding the tax year of any of the aforementioned carrybacks. Then, it will be applied to any tax or installment due from the taxpayer. Finally, if not credited elsewhere, the balance will be refunded to the taxpayer. The ruling clarifies that prior guidance, which established the IRS policy of making partial allowances of refunds or credits, does not prevent the IRS from crediting overpayments only against assessed tax liabilities, but also against outstanding tax liabilities.

6. FASB Considers Narrowing its Project on Financial Guarantee Insurance Contracts

Earlier this month, the Financial Accounting Standards Board indicated that it may narrow its project on financial guarantee insurance contracts to focus only on key aspects, such as claims liability recognition. Participants in a roundtable panel suggested narrowing the scope of the entire financial guarantee insurance exposure draft and focus only on answering questions on claims liability recognition. One board member questioned whether guarantee insurance contracts should even be considered insurance contracts, because they do not seem to act like insurance in all circumstances. The board has received dozens of comment letters on the exposure draft and expects to decide how to proceed at a board meeting held later in the month.

7. *Textron* Court Holds Certain Tax Accrual Workpapers Protected by Work-Product Doctrine

In *United States v. Textron, Inc.*, No. 1:06-cv-00198 (D.R.I., August 29, 2007), a federal District Court held that a taxpayer's tax accrual workpapers are protected by the attorney work-product doctrine and that the IRS had not met the showing of substantial need for the documents that is necessary to obtain an opponent's attorney work product. In the facts of the case, the taxpayer engaged in various listed transactions, including so-called "sale-in, lease out" (SILO) transactions during the 1998-2001 years in dispute. During its audit, the IRS issued a summons for all of the taxpayer's tax accrual workpapers for tax year 2001, under a well-known policy reflected in the Internal Revenue Manual. The workpapers at issue consisted of spreadsheets and draft spreadsheets identifying issues on the taxpayer's tax return, that its counsel deemed "uncertain." The spreadsheets, which were prepared by the taxpayer's accountants, in-house counsel and outside counsel were used on a yearly basis to summarize tax reserve items for financial accounting purposes, and were provided on a confidential basis to the taxpayer's independent auditors.

The court held that the attorney-client privilege and the tax practitioner privilege under I.R.C. § 7525 (which generally tracks the attorney-client privilege) applied to the documents, but that the taxpayer waived those privileges when it provided the final spreadsheet to its independent auditors. However, the court found that the work-product doctrine, also applicable to the tax accrual workpapers, serves a somewhat different purpose and thus has a different waiver standard. The taxpayer provided the spreadsheets to its auditors, with the understanding that the auditors would maintain confidentiality and the auditors had a professional obligation to oblige. Therefore, the court held that, by providing the spreadsheet to its auditors, the taxpayer did not do anything inconsistent with the underlying purpose of keeping the documents from its potential adversary (the IRS) and thus did not waive the work-product privilege.

8. IRS Requests Comments on Insurance Contracts Information Return

Published as a notice in the Federal Register (72 F.R. 51905), the IRS has asked for comments on Form 8921, "Applicable Insurance Contracts Information Return." The comments are to be submitted by November 13, 2007.

***IRS Circular 230 Disclosure*:**

This newsletter is provided solely for informational purposes and is not intended to furnish legal advice with respect to the reader's particular factual circumstances. In accordance with § 10.35 of IRS Circular 230 requirements, you are advised that any discussion of tax issues in this newsletter is not intended or written to be used, and cannot be used, to avoid penalties imposed under the Internal Revenue Code or to promote, market or recommend to another party any transaction or matter addressed herein. The persuasiveness of this newsletter's discussion with regard to the tax issues in question and a taxpayer's good faith reliance on the newsletter will be determined under applicable provisions of the law and regulations (§ 10.35(f)).

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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