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TAX ISSUES SUMMARY

October 29, 2007

***HIGHLIGHTS*:**

I.R.C. §§ 419 and 419A — IRS Attacks Welfare Benefit Funds Using Cash Value Life Insurance

The IRS issued Notice 2007-83, Notice 2007-84 and Rev. Rul. 2007-65, targeting the use of certain trust arrangements funded by cash value life insurance and sold to taxpayers as a welfare benefit fund arrangement, intended to provide tax-deductible employer contributions exceeding certain specified limits. Notice 2007-83 announces that certain of such arrangements are "listed transactions" subject to disclosure requirements. Notice 2007-84 announces that the IRS intends to scrutinize or challenge the purported tax treatment of all the described arrangements and, if successful, will assert all applicable penalties. Rev. Rul. 2007-65 concludes that, for purposes of determining the limitations on an employer's deduction for contributions to a welfare benefit fund under I.R.C. § 419 and I.R.C. § 419A, premiums on cash value life insurance policies paid by the fund, whenever the fund is directly or indirectly a beneficiary under the policy, are not included in the fund's "qualified direct cost," because such amounts would not have been deductible if paid by the employer directly under I.R.C. § 264(a). *See* Policyholder Issues.

I.R.C. §§ 807 and 812 — IRS Suspends Rev. Rul. 2007-54

With Rev. Rul. 2007-61, 2007-42 I.R.B. 799 (Sept. 25, 2007), the IRS and Treasury suspended Rev. Rul. 2007-54, 2007-38 I.R.B. 604 (Aug. 16, 2007), which had concluded that, if an I.R.C. § 807(d)(2) reserve computed for a variable contract was greater than the net surrender value of the contract, required interest for the variable contract appropriately would be computed using the applicable Federal interest rate (AFIR) times the mean of the reserves. Rev. Rul. 2007-61 indicates that a regulations project will address the issues of the suspended ruling and "[u]ntil such time, the issues should be analyzed as though Rev. Rul. 2007-54 had not been issued." *See* Company Issues.

LEGISLATION

1. In General — Rangel Introduces Tax Reform Bill

Last week, House Ways and Means Chairman Charles Rangel (D-NY) introduced his long-awaited "mother of all tax bills" — Tax Reduction and Reform Act of 2007 (H.R. 3970). The bill would (a) repeal the alternative minimum tax (AMT) for individuals after 2007, (b) extend the AMT patch for 2007, (c) increase the earned income tax credit, the child care credit and the standard deduction, and (d) extend all expiring tax provisions for one year. The bill was made revenue neutral by (a) imposing a 4-percent surtax on adjusted gross income (AGI) in excess of $200,000 and a 4.6-percent surtax on AGI over $500,000, (b) restoring the phase out of personal exemptions and the overall limitations on itemized deductions for taxpayers with AGI exceeding $250,000, and (c) modifying the 2-percent floor on miscellaneous itemized deductions. Other individual tax reforms that would raise revenue include (a) taxation of carried interest, (b) current inclusion of deferred compensation paid by offshore hedge funds to investment managers, (c) modification of unrelated business income tax rules to allow pension plans, universities and other tax-exempt entities to invest directly in hedge funds, (d) clarification of shareholder-employees of service S corporations and partner-employees of service partnerships liability for self-employment taxes, and (e) basis reporting by brokers on sales of stock. Rangel described the revenue neutrality as looking to the "disparity that exists between middle income and those that are more fortunate in income," trying to spread the tax relief.

The bill includes a corporate tax section that would reduce the top corporate marginal tax rate from 35 percent to 30.5 percent and make permanent current enhanced small business expensing rules. The cost of these corporate provisions would be offset with revenue from (a) repeal of the I.R.C. § 199 domestic production activities deduction, (b) modification to the allocation of expenses and taxes on repatriation of foreign income, (c) repeal of LIFO accounting over eight years and repeal of lower-of-cost-or-market accounting, (d) the increase of I.R.C. § 197 amortization of intangibles to 20 years, (e) reduction of the 80-percent dividends-received deduction to 70 percent, and the 70-percent deduction to 60 percent, (f) termination of the domestic international sales corporation provisions, (g) treatment of distributions of debt securities in a tax-free spin-off transaction in the same manner as distributions of cash or other property, (h) limitation on treaty benefits for certain deductible payments, and (i) codification of the economic substance doctrine. Republican members of Congress generally have characterized H.R. 3970 as the "mother of all tax hikes."

H.R. 3970 separately provides a one-year AMT patch and a one-year extension of expiring provisions so that these provisions can be moved forward in the coming month (a temporary patch has been the preferred legislative action for 2007), leaving consideration of the broader "tax reform" proposals to be considered next year at the earliest.

2. JCT Report Analyzes Income Deferrals for International Taxes and Reinsurance Deductions

On September 24, the Joint Committee on Taxation (JCT) issued a report (JCX-85-07) analyzing the potential abuses of U.S. individuals and businesses using overseas practices to defer services income

earned from abroad and of U.S. insurance companies using foreign-based insurance companies to avoid U.S. taxes through the misuse of tax deductible reinsurance premiums. The report pointed to several issues before Congress concerning international taxation, including proposed bills from Reps. Sander Levin (D-Mich.) and Rahm Emanuel (D-Ill.) Levin's proposed bill (H.R. 3501) would exempt charities and other tax-exempt entities from the debt-finance rules, allowing them to invest in onshore hedge funds without being subject to unrelated business income tax (UBIT). Emanuel's proposed bill would limit the amount of money that can be deferred to the combined limit for I.R.C. § 401(k) plan contributions and individual retirement account contributions.

In a hearing before the Senate Finance Committee on September 26, the Coalition for a Domestic Insurance Industry, a coalition of fourteen U.S.-based commercial insurers, urged correction of what they view as competitive disadvantages enjoyed by insurers who have migrated to low or no-tax countries, such as Bermuda and the Cayman Islands, saying that current tax laws allow a foreign-based company to avoid paying U.S. tax on domestic underwriting and investment income by operating through a U.S. subsidiary that reinsures that business with an offshore insurer. The Association of Bermuda Insurers and Reinsurers, which represents twenty-three Bermuda-based insurers, argues that the U.S. subsidiaries pay U.S. income tax on their world-wide income and Bermuda-based insurers also pay the U.S. insurance excise tax, regardless of whether they operate at a profit or a loss for the year.

3. Information Requested from Long-Term Care Insurance Providers

Ranking Senate Finance Committee member Charles Grassley (R-Iowa) sent a letter to eleven major long-term care providers requesting information on how the companies manage their policies and what criteria are used to approve or deny claims. Apparently, the request was in response to figures reported by the National Association of Insurance Commissioners (NAIC) that there has been a 92 percent increase in long-term care complaints from 2001 to 2006, as well as a steady increase in the number of complaints regarding claim denials, and that 70 percent of denials are overturned on appeal. Grassley said he was concerned because, if claims continue to be denied, it could result in a substantial and possibly unnecessary burden on Medicaid.

POLICYHOLDER ISSUES

1. I.R.C. § 72 — IRS Rules I.R.C. § 72 Precludes Constructive Receipt Applying to a Deferred Charitable Gift Annuity

In PLR 200742010 (July 19, 2007), the IRS ruled that, where payments are made in accordance with I.R.C. § 72 and Treas. Reg. § 1.72 under a deferred charitable gift annuity issued by an I.R.C. § 501(c)(3) charitable organization, no amount will be treated as constructively received until the amounts are actually received by the annuitant. The ruling notes that I.R.C. § 72(a) and (e) provide rules for taxing amounts "received as annuities" and amount "not received as annuities," requiring that amounts be "received" by the holder/annuitant before they are included in gross income. It also notes that the statute is silent as to whether amounts that are only constructively received are "received" for purposes of I.R.C. § 72. The IRS also looked to operation of various Code provisions, as well as to

legislative history of I.R.C. § 72 provisions to support its conclusion that the annuitant will not be considered to have constructively received any amount from the deferred charitable gift annuity until payments are actually received.

2. I.R.C. § 104 — Murphy Petition for En Banc Review in *Murphy v. IRS* is Denied

On September 14, 2007, Marrita Murphy's 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) was denied. The panel had reversed a previously taxpayer-favorable decision and held that her compensatory damage award for emotional distress is includible in gross income under I.R.C. § 104(2)(a). Murphy's lawyers had challenged the ruling stating that I.R.C. § 104(a)(2) was unconstitutional, and that the panel's ruling conflicted with other courts' rulings.

3. I.R.C. §§ 419 and 419A — IRS Attacks Welfare Benefit Funds Using Cash Value Life Insurance

The IRS issued Notice 2007-83, Notice 2007-84 and Rev. Rul. 2007-65, targeting the use of certain trust arrangements funded by cash value life insurance and sold to taxpayers as a welfare benefit fund arrangement intended to provide tax-deductible employer contributions exceeding certain specified limits. Notice 2007-83 announces that arrangements that have certain identified elements, or any substantially similar transactions, are "listed transactions" subject to disclosure requirements, and those taxpayers who otherwise would be required to file a disclosure statement prior to January 15, 2008, will have until January 15, 2008, to make the disclosure. Notice 2007-84 announces that the IRS intends to scrutinize or challenge the purported tax treatment of all the described arrangements. Moreover, if successfully challenged by the IRS, such arrangements may be subject to penalties.

Rev. Rul. 2007-65 concludes that, for purposes of determining the limitations on an employer's deduction for contributions to a welfare benefit fund under I.R.C. § 419 and I.R.C. § 419A, premiums on cash value life insurance policies paid by the fund, whenever the fund is directly or indirectly a beneficiary under the policy, are not included in the fund's "qualified direct cost," because such amounts would not have been deductible if paid by the employer directly under I.R.C. § 264(a). In addition, to the extent that the *benefit provided through the fund is life insurance coverage*, i.e., the life benefits provided are insured, such benefit payments are not included in the fund's qualified direct costs for purposes of the employer's contributions being deductible under I.R.C. § 419. However, if the benefit provided through the fund is *other than life insurance coverage* (e.g., disability benefits that are uninsured), the "qualified direct cost" includes the disability benefit amounts paid during the taxable year for claims incurred during the year. For any taxable year of an employer ending before November 5, 2007, if a deduction is otherwise allowable and the arrangement is not subject to the split-dollar regulations, an employer is allowed to take into account premium amounts paid for cash value life insurance as part of qualified direct costs to the extent such amounts do not exceed the I.R.C. § 79 amounts reportable by the employer to the employee for that year as the cost of insurance.

4. Tax Court Holds Claim Settlement Is Ordinary Income, Not Capital Gain

In *Eckersley v. Commissioner*, No. 16753-05, T.C. Memo. 2007-282 (Sept. 18, 2007), the Tax Court held that the proceeds that taxpayers received for the settlement of a claim to ownership of a life insurance policy were taxable as ordinary income rather than as a capital gain. The court reasoned that the payment was made to extinguish a claim to the policy, and was not for the sale or exchange of the policy as a capital asset.

COMPANY ISSUES

1. I.R.C. § 162 — LMSB Clarifies Directive on False Claims Act Settlements

The IRS LMSB Division issued an industry directive (LMSB-04-0707-050) to clarify field direction on issues relating to the deductibility of settlements with a governmental agency under I.R.C. § 162(a) and (f). The new directive clarifies a previously-issued directive (LMSB-04-0507-042), which covered government settlements with the Department of Justice for False Claims Act violations, by setting forth mandatory steps to be taken by examiners to involve the Issue Management Team in the development and resolution of the issues included.

2. I.R.C. § 409A — Transition Relief Extended for Nonqualified Deferred Compensation Plans

In Notice 2007-86, 2007-46 I.R.B.___, the IRS extended transition relief through 2008 for nonqualified deferred compensation plans that must comply with the requirements of the final regulations issued under I.R.C. § 409A. Prior guidance had required plans to comply with the final regulations starting in 2008. However, the extension has been granted in response to credible comments from benefit plan advisors and administrators that the first transition relief was inadequate to address the need for additional time for service recipients and providers to make the changes necessary to bring existing arrangements into compliance. The prior expiration date of December 31, 2007 provided in Notice 2007-78 for transition relief has been revoked and replaced by a new date of December 31, 2008.

3. I.R.C. §§ 807 and 812 — IRS Suspends Rev. Rul. 2007-54

With Rev. Rul. 2007-61, 2007-42 I.R.B. 799 (Sept. 25, 2007), the IRS and Treasury suspended Rev. Rul. 2007-54, 2007-38 I.R.B. 604 (Aug. 16, 2007), which had concluded that, if an I.R.C. § 807(d)(2) reserve computed for a variable contract was greater than the net surrender value of the contract, required interest for the variable contract appropriately would be computed using the applicable Federal interest rate (AFIR) times the mean of the reserves. Rev. Rul. 2007-61 indicated that, after the prior ruling was issued, some taxpayers argued that the provisions on which the ruling was based carried over from the Life Insurance Company Tax Act of 1959 to the Deficit Reduction Act of 1984 and, because Rev. Rul. 2007-54's analysis was inconsistent with some authorities under the 1959 Act, the ruling should not be applied retroactively. Rev. Rul. 2007-61 states that "it is important that the company's share and the policyholders' share of net investment income be determined in a manner that effectively prevents the double benefit that otherwise would result from the use of tax favored investment

income (such as dividends qualifying for the dividends received deduction) to fund the company's obligations to policyholders." Rev. Rul. 2007-61 indicates that a regulations project will address the issues of the suspended ruling and "[u]ntil such time, the issues should be analyzed as though Rev. Rul. 2007-54 had not been issued."

4. I.R.C. §§ 807 and 832 — Cross References in Code Do Not Take Exceptions into Account

In PLR 200738016 (May 3, 2007), the IRS ruled that the references to "contracts to which section 264(f) applies" in I.R.C. §§ 807(a)(2)(B), 807(b)(1)(B) and 832(b)(5)(B)(iii), which prorate an insurance company's investment income to preclude the funding of deductible reserves with tax-favored income, do not take into account exceptions to the application of the interest disallowance rule of I.R.C. § 264(f). The IRS issued an additional ruling, PLR 200738017 (Sept. 11, 2007), which modifies the first ruling to incorporate the safe harbor described in Rev. Proc. 2007-61 (which was discussed in the *Tax Issues Summary* for September) and clarifies that the taxpayer may rely on the safe harbor if the proposed transaction is within its scope.

5. I.R.C. § 847 — Company May Not Elect Deduction, Recategorize Estimated Tax Payments After Unreasonable Period of Time

In FAA 20073802F (Aug. 7, 2007), the IRS concludes that a company may not file amended tax returns more than a decade after the original returns were due to elect to take an I.R.C. § 847(1) deduction and recategorize its regular estimated tax payments as I.R.C. § 847(2) special estimated tax payments. In the facts of the advice, a company filed timely returns for four tax years, and later filed timely amended returns for those years in order to recategorize certain existing taxes paid as special estimated tax payments. The amended returns, however, did not indicate that the company had elected to take an I.R.C. § 847 deduction or that special estimated tax payments were made. I.R.C. § 847 provides that for tax years starting on January 1, 1988 an insurance company required to discount unpaid losses may elect to take a deduction equal to the amount of the discount. To be eligible to take this deduction, the taxpayer must make special estimated tax payments by the due date of the tax return as prescribed by I.R.C. § 847(2). In the advice, the IRS reasoned that the company was not entitled to file amended returns because they were filed more than a decade after the due date, which was an unreasonable period of time. The IRS also noted that the company failed to comply with the requirements to take the deductions on the original returns and did not keep records of its special loss discount accounts or the special estimated tax payments for the tax years at issue.

6. I.R.C. § 6011 and 6111 — Proposed Regulations re Tax Patents

The IRS has issued proposed regulations (REG-129916-07) that would add a new reporting category to the I.R.C. § 6011 regulations. The new category would include "patented transactions," defined as a transaction for which a taxpayer pays a fee in any amount to a patent holder or the patent holder's agent for the legal right to use a tax planning method that the taxpayer knows or has reason to know is the subject of the patent. A patented transaction is also a transaction for which a taxpayer has the right to payment for another person's use of a tax planning method that is the subject of the patent. The proposed regulations explain what the criteria is for participation in a patented transaction under the

regulation. In addition, the proposed regulations also describe when a person is considered a material advisor with respect to a patented transaction under I.R.C. § 6111. The proposed regulations address the concerns of the IRS and Treasury, as well as commentators, that the patenting of tax advice or tax strategies have the potential for tax avoidance. The IRS requests comments and request for a public hearing be submitted to be received by December 26, 2007.

7. I.R.C. § 3402 — Employer Properly Withheld on Settlement Payment to Employee as Supplemental Wages under Aggregate Method

In *Cunningham v. Blue Care Network of Michigan*, 100 A.F.T.R. 2d 2007-5958 (E.D. Mich. 2007), the district court concluded that a settlement payment to a discharged employee was properly treated as supplemental wages (rather than regular wages, as contended by the former employee) for income tax withholding purposes. The court further determined that the employer's use of the aggregate method of withholding on the gross settlement amount was consistent with the settlement agreement, which provided the employer would make appropriate tax withholdings as required by law. The court concluded that, under both the settlement agreement and IRS regulations, the employer had the option of using the aggregate method described in Treas. Reg. § 31.3402(g)-1(a)(6), rather than the flat-rate method provided in Treas. Reg. § 31.3402(g)-1(a)(5). The court also agreed with the employer that the former employee suffered no damages because she could easily request that the IRS refund any overpayment or apply it to her tax liability for the following tax year. The court granted the employer's motion for summary judgement and dismissed the suit.

8. Treas. Reg. § 1.1502-13 — IRS Issues Proposed Regulations on Treatment of Intercompany Obligations

The IRS has issued proposed regulations (REG-107592-00) on the treatment of transactions involving obligations between consolidated group members and on transactions involving the provision of insurance between group members. The proposed regulations replace previously issued outdated proposed regulations (REG-105964-98). In addition to other provisions, the new proposed regulations do not allow separate-entity treatment for direct insurance transaction when a significant amount of the insuring member's business arises from transactions with other group members. The regulations state that when five percent or more of the business of the insurer member arises from insuring the risks of other group members, the taxpayer must account for the items from the intercompany transaction on a single-entity basis. The IRS is seeking comments and requests for a public hearing to be received by December 27, 2007.

9. Taxpayer Not Estopped from Filing Claim for Refund by Form 870-AD

In ILM 200738010 (June 5, 2007), the IRS concluded that a taxpayer may file amended tax returns claiming I.R.C. § 41 research tax credits and I.R.C. § 174 research and development deductions despite having previously filed Forms 870-AD for the same tax years. In the memorandum, the IRS looked at whether the filing of a Form 870-AD bars a subsequent claim for refund, and whether that filing would estop a taxpayer from filing an amended return. The IRS relied on case law from the Ninth Circuit, where the taxpayer is domiciled, in reaching its conclusion. According to case law, merely filing a Form 870-AD does not bar a refund claim. To oppose a claim, there must be additional factors present

that the taxpayer should be estopped from making the refund claim. The IRS further reasoned that estoppel did not apply because the taxpayer did not misrepresent any issue resolved by the Forms 870-AD, and because the facts giving rise to the refund claims were not discovered by the taxpayer until after the forms were filed.

10. IRS Issues Coordinated Issue Paper to Address Cost-Sharing Arrangement and Buy-In Adjustments

The IRS issued coordinated issue paper LMSB-04-0907-62 to provide guidance on methods for evaluating the arm's-length charge for preexisting intangible property (the "buy-in intangible") that is made available to a qualified cost-sharing arrangements. The coordinated issue paper is available at http://www.irs.gov/businesses/article/0,,id=174320,00.html.

11. Issues to Be Focus of IRS Interest Identified at TEI Conference

Speaking at a Tax Executives Institute (TEI) financial services industry conference on October 11, Diane Helfgott (a senior tax attorney with the IRS LMSB Division) indicated that the IRS would be looking at "insurance securitization" issues, but that it does not have refined and established positions on the issues yet. She said that she wanted to consider whether securitized insurance ought to be treated differently from other sorts of bonds, what role risk transfer plays and whether a tax deduction for the use of other people's money is appropriate. With regard to a Guidance Priority Plan project to define statutory life insurance reserves, Helfgott said that the definition needs to change because the assumptions made in 1984 are increasingly no longer true.

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