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TAX ISSUES SUMMARY

December 27, 2007

HIGHLIGHTS:

I.R.C. §§ 832 and 846 — IRS Issues Salvage Discount Factors and Loss Payment Patterns and Discount Factors for 2007

In Rev. Proc. 2008-11, 2008-3 I.R.B. ___, the IRS has published the salvage discount factors for the 2007 accident year. Also, in Rev. Proc. 2008-10, 2008-3 I.R.B. ___, it has published the loss payment patterns and discount factors for the 2007 accident year. *See* Company Issues.

I.R.C. § 988 — IRS Rules on Exchange-Traded Notes

In Rev. Rul. 2008-1, 2008-2 I.R.B. ___, the IRS issued guidance clarifying its position on the characterization of prepaid forward contracts or exchange-traded notes for which purchase and redemption amounts are priced in U.S. dollars, and has ruled that an exchange-traded note based on foreign currency is debt for U.S. federal tax purposes. *See* Company Issues.

LEGISLATION

1. In General

Congress waited until the last few days of the session to finally act on several tax projects. The “must do” individual alternative minimum tax (AMT) patch was passed by both houses, finally, on the last day of the session, and was signed by the President yesterday. The House of Representatives bowed to the Senate’s bill providing a one-year patch without offsetting revenue raisers — both houses abandoned the pay-go rules adopted at the beginning of 2007. In another unusual occurrence, tax-wise, technical corrections were removed from the military tax relief bill and passed as a stand-alone bill (H.R. 4839), the Tax Technical Corrections Act of 2007. Included in the technical corrections of provisions of the Jobs Act of 2004 are a clarification of the sale-in, lease-out (SILO) provision for real

estate and venture capital partnerships and a clarification of the treatment of losses in identified straddles when there are no offsetting positions with unrecognized straddle-period gain and when an offsetting position is or has been a liability to the taxpayer. So far, the technical corrections bill remains unsigned.

Congress also passed, and the President signed yesterday, an omnibus appropriations bill to fund the federal government through the 2008 fiscal year.

2. Bush Expected to Sign Legislation on Mortgage Tax Relief

On December 18th, the House passed a measure to help homeowners by excluding from gross income up to \$1 million in debt forgiven on a mortgage. The exemption is limited to a taxpayer's primary residence and only applies to debt forgiven during tax years 2007, 2008, and 2009. The "Mortgage Forgiveness Debt Relief Act of 2007" (H.R. 3648) was passed by the Senate on December 14th. The president is expected to sign the legislation as part of a broader plan to assist homeowners facing default on sub-prime mortgages. In addition to exempting debt forgiven from income, the bill also would treat as nontaxable income 50 percent of state and local tax rebates or reductions given to volunteer emergency responders.

3. Bill Introduced to Make a Portion of Lifetime Annuity Payments Non-Taxable

In mid-November Congressman Earl Pomeroy (D-N.D.) introduced H.R. 4150, the "Lifetime Pension Annuity for You Act," which would make a portion of lifetime income payments received under IRAs, qualified retirement plans (other than defined benefit plans) and similar employer-sponsored retirement plans, as well as non-qualified annuities, non-taxable. For federal income tax purposes, the bill would exclude from gross income 25 percent of qualified annuity payments, up to \$5,000, and 50 percent of nonqualified annuity payments up to \$5,000 per year. The exclusion limits would be doubled for joint filers.

POLICYHOLDER ISSUES

1. I.R.C. § 61 — Damages Paid Are Not Includable in Gross Income

In PLR 200748010 (Aug. 29, 2007), the IRS ruled that pre- and post-judgment interest and amounts paid to a qualified settlement fund for damages, including attorneys' fees and costs and disbursements related to litigation, are not included in the fund's modified gross income. In the facts of the ruling, a jury found that a corporate defendant in a consumer fraud class action suit must pay compensatory and punitive damages to claimants, including pre- and post-judgment interest, expenses and costs of litigation, incentive fees to class representatives, and other legal and administrative costs. A fund was established to pay these costs. The IRS said that the fund is a qualified settlement fund under Treas. Reg. § 1.468B-1 and that the interest and other amounts paid by the corporation to the fund are not included in the fund's modified gross income. Class members will not incur gross income from the payments made to third parties from the fund for costs related to the litigation, for fund administration, or for the portion of the fund awarded to class counsel, and the fund does not have a reporting obligation to class members for such third party payments under I.R.C. § 6041. The fund also does not have a

reporting obligation for payments made to class members for compensatory damages. However, the IRS said that payments made to class members for punitive damages will be reportable under I.R.C. § 6041, and the fund must also report the amount of an incentive award paid to a class representative.

2. I.R.C. § 101 — IRS Grants Waiver for Clerical Errors

In PLR 200749005 (Aug. 24, 2007), the IRS ruled that a waiver would be granted where life insurance contracts ceased to qualify under I.R.C. § 101 due to clerical errors. In the ruling, a life insurance company discovered that a number of its policies had ceased to qualify as flexible premium life insurance contracts under I.R.C. § 101(f) because of clerical errors caused by actions taken in violation of the company's detailed and clearly stated policies designed to ensure compliance with federal tax laws. The company said that the failure of customer service representatives to follow the established procedures of processing the required return of excess premiums caused the non-compliance. The IRS said that the failure of the policies to satisfy the tax code requirements was due to reasonable errors and granted a waiver for the errors. The IRS noted that the taxpayer plans to bring the policies into compliance by increasing death benefits or refunding premiums where appropriate. In addition, the taxpayer has implemented a new system to administer compliance, which the IRS said will eliminate much of the manual processing that was the source of the errors.

3. I.R.C. § 403 — IRS Provides Model Plan Language for Tax-Sheltered Annuity Contract Plans

In Rev. Proc. 2007-71, 2007-51 I.R.B. 1184, the IRS has provided model plan language that may be used by public schools to adopt a written plan or to amend its I.R.C. § 403(b) plan to reflect the requirements of I.R.C. § 403(b) and corresponding regulations. Any public school employer may comply with the requirements of the final regulations by adopting the model provisions provided in the revenue procedure. The language provided takes into account the general requirement that an I.R.C. § 403(b) plan must include all the material terms and conditions for benefits under the plan. According to the procedure, adopting the entire model language by a public school has the same status as a private letter ruling that provides that the written form of the plan satisfies I.R.C. § 403(b). In addition, the plan will be treated as having been timely amended to reflect a requirement of the final regulations, if an amendment that satisfies that requirement is adopted no later than the first day of the first tax year after December 31, 2008. The procedure also provides guidance on how an eligible, non-public school employer may use the sample language to comply with the requirements of I.R.C. § 403(b). The IRS has requested comments on the model language and also on several specific questions laid out in the procedure. Comments should be received no later than March 16, 2008.

4. I.R.C. § 2042 — Beneficiaries of Contract Do Not Possess Incidents of Ownership for Estate Tax Purposes

In PLR 200747002 (Nov. 23, 2007), the IRS ruled that parties to a buy-sell agreement, who are beneficiaries of life insurance policies owned by an LLC entity established to assure proceeds are available for purchasing deceased insured's interests in companies, will not possess incidents of ownership with respect to such policies. The facts of the ruling state that a grantor set up a revocable trust, which, upon his death, would separate into two separate trusts, each for the benefit of one of his children. The grantor also created two additional irrevocable trusts for the benefit of his children and

their descendants. In addition, the children created separate revocable trusts. The children's trusts own interests in a business corporation, as does the trust of an unrelated associate who obtained shares under his employment agreement with the business corporation. The children and the unrelated associate own life insurance policies on each other's lives pursuant to the terms of a buy-sell agreement covering the corporation and a related LLC. According to the agreement, the policy proceeds are intended to be used by the surviving shareholders to purchase the deceased's stock or interest, and authorizes the creation of an "insurance LLC" to hold insurance on the participants' lives for this purpose. The IRS said in the ruling that neither the children nor their associate will possess incidents of ownership, under I.R.C. § 2042, with respect to the policies owned by the insurance LLC. Further, the IRS ruled that the children's trusts will be treated as grantor trusts under I.R.C. § 678, assuming no additional contributions are made to them.

5. I.R.C. § 2511 — Payment Made Under Agreement Not Considered Gift

In PLR 200747011 (Aug. 7, 2007), the IRS ruled that payment made under an agreement executed prior to the promulgation of T.D. 9092 will not result in a "gift" under I.R.C. § 2511. In the facts of the ruling, three adult children purchased a second-to-die life insurance policy on their parents' lives, with equal interest as beneficiaries. The children entered into a split-dollar insurance agreement under a revocable trust established by the parents. The agreement stipulates that the children must pay a portion of the annual premium due and that the trust must pay the balance of the premium. If the agreement is terminated, the trust will receive an amount calculated by reference to the cash surrender value of the policy. In addition, the children have executed an assignment to the trust of their interest in the policy to secure its right to repayment. The IRS ruled that the payment by the trust of its portion of the premium will not result in a gift to any of the children under I.R.C. § 2511, as the agreement was executed in 1998, and so is not subject to the split-dollar life insurance regulations promulgated in T.D. 9092. The IRS also ruled that proceeds of the policy payable to the children will not be includable in the gross estate of the second to die of the parents under I.R.C. § 2042. However, the portion of the proceeds of the policy payable to the surviving spouse's trust established under the family trust will be includable in the gross estate of the last to die of the parents.

6. I.R.C. § 7702 — ACLI Suggests that IRS Waive Toll Charge for Minor Failures

The American Council of Life Insurers (ACLI) suggested three changes in the current correction regime for inadvertent failures of life insurance or annuity contracts to streamline the contract correction process. The ACLI suggested that the IRS could significantly streamline the correction process by publishing a list of automatically remediable errors, by waiving toll charges for certain I.R.C. § 7702A contract failures and imposing per contract and per filing maximum amounts on non-egregious contract failures for which a specific error cannot be readily determined, and by substantially reducing the amount of information required to be submitted. The ACLI notes that, since the correction procedure found in I.R.C. § 7702 was implemented 16 years ago, a consistent pattern of contract failures has emerged, and the IRS has issued many private letter rulings waiving contract failures that have been deemed reasonable. The ACLI recommended that the IRS use these rulings to compile a list of remediable errors

that will automatically be considered reasonable and therefore available, as well as a list of the types of I.R.C. § 7702A and I.R.C. § 817(h) errors that will automatically be considered inadvertent and therefore subject to routine correction.

7. Lawmakers Seek Treasury Assistance on STOLI Transactions

Members of the House Ways and Means Select Revenue Measures Subcommittee sent Treasury Secretary Henry Paulson a letter on November 16th urging him to alert elderly taxpayers to the tax implications of reselling life insurance policies. Stranger-originated, or stranger-owned, life insurance (STOLI) transactions have been the focus of lawmakers for some time, and now they are requesting assistance from the Treasury. Lawmakers say that they are not trying to inhibit an individual's ability to sell life insurance policies, but rather want the Treasury's assistance in notifying elderly taxpayers on possible adverse tax consequences that can come about from STOLI transactions.

8. IRS Counsel Expects Litigation on Listed Transactions Involving Life Insurance Products

At a D.C. Bar Taxation Section luncheon on December 13th, Charles Pillitteri, counsel for the IRS Small-Business/Self-Employed Division (SB/SE), said the SB/SE expects to litigate a substantial number of cases involving I.R.C. §§ 419A(f)(6) and 412(i) plans, employee stock ownership plan transactions, and conservation easements. He said that, in those cases, SB/SE plans to coordinate closely with counsel from the IRS Tax-Exempt and Government Entities Division.

COMPANY ISSUES

1. I.R.C. § 402 — IRS Modifies Exclusion Guidance to Include Premiums Paid to Self-Insured Plan

In Notice 2007-99, the IRS modified Q&A-23 of Notice 2007-7, 2007-5 I.R.B. 395, to provide that the section 402(l) exclusion for an eligible governmental plan's distributions to pay qualified health insurance premiums may apply in the context of self-insured accident or health plans. The term "qualified health insurance premiums" is defined in the statute as premiums paid directly to the provider of accident or health *insurance* or qualified long-term care insurance contract. In anticipation of a technical correction deleting the reference to "insurance," Q&A-23 has been amended to provide that an accident or health plan, which is defined under section 105(e), includes a self-insured plan.

2. I.R.C. § 409A — Transition Relief and Guidance for Correcting Operational Failures

The IRS has issued Notice 2007-100, 2007-52 I.R.B. 1243, providing transitional relief and guidance on corrections for certain I.R.C. § 409A operational failures. In the Notice, the IRS provides relief for certain operational failures that are corrected in the same year and also transition relief through 2010 for operational failures up to a certain amount that are not corrected in the same taxable year by limiting the amount of income inclusion and additional taxes. In addition, the Notice describes and requests comments on a potential expanded program that would limit the income inclusion and additional

taxes under I.R.C. § 409A for certain operation failures involving larger amounts. The Notice includes information reporting requirements relating to these filed contracts. The service recipient must attach to its timely-filed (including extensions) original federal income tax return for its taxable year in which the failure occurred a statement entitled “§ 409A Relief under § II of Notice 2007-100,” setting out certain information, e.g., description of the failure and the steps taken to correct the failure (Failure Information), and must provide to each service provider affected by such failure a statement entitled “§ 409A Relief under § II of Notice 2007-100,” setting out similar Failure Information, by no later than the date (with extensions) on which it is required to provide an information return (Form W-2 or 1099) to such service provider for the calendar year in which such failure occurred. In addition, upon the commencement of an examination of such taxpayer’s federal tax return, each taxpayer must generally provide notice to the examining agent of the taxpayer’s reliance on the Notice for years covered by the examination.

In connection with transition relief for certain operational failures involving limited amounts, additional requirements are generally imposed. First, the service recipient must attach to its timely-filed (including extensions) original federal income tax return for its taxable year in which it discovers the failure a statement entitled “§ 409A Relief under § III of Notice 2007-100” setting out similar Failure Information, and must provide to each such service provider a statement entitled “§ 409A Relief under § III of Notice 2007-100” including similar Failure Information not later than the date (with extensions) on which it is required to provide an information return (Form W-2 or 1099) for the calendar year in which it discovers such failure to a service provider who is affected by such failure. A service provider who is relying on the transition relief with respect to a failure to comply with I.R.C. § 409A must attach to its timely-filed (including extensions) original federal income tax return, for the year in which such failure was discovered, information similar to Failure Information. In addition, each taxpayer relying on this transition relief must disclose to the examining agent upon the commencement of an examination of such taxpayer’s federal tax return of the taxpayer’s reliance on the Notice for years covered by the examination.

3. I.R.C. § 832 — IRS Issues Salvage Discount Factors for 2007

In Rev. Proc. 2008-11, 2008-3 I.R.B. __, the IRS has published the salvage discount factors for the 2007 accident year. These factors will be used for computing discounted estimated salvage recoverable under I.R.C. § 832.

4. I.R.C. § 846 — IRS Issues Loss Payment Patterns and Discount Factors for 2007

In Rev. Proc. 2008-10, 2008-3 I.R.B. __, the IRS has published the loss payment patterns and discount factors for the 2007 accident year. Under I.R.C. § 846(d), the most recent aggregate loss payment data of property and casualty insurance companies is used to determine and publish a loss payment pattern for each line of business every five years. The loss payment pattern released in this revenue procedure will apply through the 2011 accident year.

5. I.R.C. § 988 — IRS Rules on Exchange-Traded Notes

In Rev. Rul. 2008-1, 2008-2 I.R.B. ___, the IRS issued guidance clarifying its position on the characterization of prepaid forward contracts or exchange-traded notes for which purchase and redemption amounts are priced in U.S. dollars, and has ruled that an exchange-traded note based on foreign currency is debt for U.S. federal tax purposes. Under I.R.C. § 988(c)(1), obligations involving nonfunctional currency may be characterized as debt, even though the dollar-equivalent return at maturity may be less than the acquisition costs because of fluctuations in currency exchange rates. The IRS said that, although the holder may end up with fewer U.S. dollars than it had invested, this does not affect the characterization of the instrument as debt. In related Notice 2008-2, 2008-2 I.R.B. ___, the IRS requested comments on issues related to prepaid forward contracts or exchange-traded notes, including whether parties to these transactions should be required to accrue income or expense during the term of the transaction when the transaction is not treated as a debt for federal income tax purposes. Comments are due by May 13, 2008.

6. I.R.C. § 6676 — IRS Explains Calculation of Penalty for Excessive or Erroneous Tax Claims

In CCA 20747020 (Oct. 3, 2007), the IRS explained that the penalty for excessive or erroneous claims for income tax refunds or credits under I.R.C. § 6676 is calculated as 20 percent of the excessive amount. The statute defines “excessive amount” as the amount by which the claim for refund or credit exceeds the allowable amount of the claim, however the IRS said that the earned income credit is not included in determining the excessive amount. The IRS also noted that the penalty will not apply if the taxpayer can show a reasonable basis for the claim for the refund or credit, or if any portion of the excessive amount of the claim is subject to penalty under I.R.C. §§ 6662, 6662A or 6663. Additionally, the IRS said that if the claim originates with a credit offset for tax, then that offset is included in the computation of the penalty, except for the earned income tax credit.

7. FASB Will Address Premium Recognition for Financial Guarantee Insurance Contracts

Last month the Financial Accounting Standards Board (FASB) said it would address premium revenue recognition as part of its project on accounting for financial guaranty insurance contracts, but would change its original proposal. Respondents to the board’s prior exposure draft generally did not like what the board was proposing and requested that the issue not be addressed at all. The FASB said that it would limit the scope of its consideration to financial guaranty insurance (and reinsurance) issued by insurance enterprises included in the scope of Paragraph 6 of FAS No. 60; it would not cover financial guarantee contracts or insurance contracts issued by non-insurance enterprises that are similar to financial guaranty insurance contracts issued by insurance enterprises. Although many respondents pointed out that the proposed limited scope would create complexity and reduce comparability, the FASB said that expanding the scope would delay the issuance of needed guidance to resolve current price issues regarding financial guaranty insurance issued by insurance enterprises. Further information may be found at www.fasb.org/project/financial_guarantee_insurance.shtml.

8. Court Rules Retaliatory Tax on Alien Corporations Constitutional

In *Sun Life Assurance Co. of Canada v. Manna*, Doc. No. 103849 (Ill. Nov. 29, 2007), the Illinois Supreme Court ruled that the state's retaliatory tax on alien corporations was constitutional. In the facts of the case, Sun Life Assurance Co. of Canada, a Canadian corporation, was treated as an "alien" under Illinois insurance code. Under the state code, insurance companies doing business in Illinois are subject to a retaliatory tax if they are organized either under the state law of a state other than Illinois, or under the laws of another country. Sun Life did not pay the retaliatory tax for the years 1997 through 2003 because, it argued, it would owe no Canadian tax on its life insurance business in Canada. The Division of Insurance of the Illinois Department of Financial and Professional Regulation assessed Sun Life approximately \$4 million in retaliatory taxes for those years. At trial, Sun Life argued that the retaliatory tax violated the uniformity and equal protection clauses of the Illinois Constitution, as well as the Foreign Commerce Clause of the United States Constitution. The appellate court found that the tax was imposed only on corporations whose home states imposed more onerous burdens on Illinois insurers than Illinois would otherwise impose on those corporations. The court found that the tax was an incidental intrusion that was not directed at one particular nation, but was applied to all alien insurers equally. For those reasons, the court held it did not violate the uniformity or equal protection clauses. The Illinois Supreme Court said that all foreign and alien insurance companies must pay the retaliatory tax, regardless of their origin, and that the tax is calculated according to the taxes of the corporation's port of entry, not the corporation's home country. In the case of Sun Life, the "port of entry" is Michigan, and so the tax will be calculated using Michigan figures, not Canadian. The court further ruled that there was no Commerce Clause violation because Congress has not enacted legislation prohibiting the imposition of any retaliatory taxes on alien insurers that would supercede the provisions of the McCarran-Ferguson Act, which allows states to regulate alien insurers.

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