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TAX ISSUES SUMMARY

January 30, 2008

HIGHLIGHTS:

I.R.C. § 162 – IRS Rules on Protected Cell Character and Deductibility of Premiums

In Rev. Rul. 2008-8, 2008-5 I.R.B. ____, the IRS issued guidance, and requested comments, on the standards for determining whether arrangements entered into with protected cells constitute insurance for federal income tax purposes and whether a protected cell is an insurance company (separate from the protected cell company that establishes the cell). The IRS also issued Notice 2008-19, which announces proposed guidance that would include a rule to the effect that an individual cell of a cell company would be treated as an insurance company separate from any other entity. *See* Company Issues.

I.R.C. § 807 — Notice re Proposed Methods for Computing Life Insurance and Variable Annuity Reserves

Notice 2008-18, 2008-5 I.R.B. ____, alerts life insurance companies to federal income tax issues that may arise as the result of the adoption of proposed Actuarial Guideline VACARVM (Proposed AG VACARVM) for variable annuity contracts and/or a proposed principles-based approach for calculating statutory reserves for life insurance contracts (Proposed Life PBR). The Notice acknowledges that these proposed methods have not been adopted by the NAIC yet, but indicate that the Treasury Department and the IRS want to start considering the tax issues that arise, assuming that I.R.C. §§ 807, 816 and 7702 are not amended by Congress. Under eight general issue subheadings, the Notice sets forth a variety of positions that the Treasury and the IRS might take and asks for comment. Comments should be submitted in writing on or before May 5th. *See* Company Issues.

LEGISLATION

1. Tax Stimulus Package — Senate and House May Have Different Priorities

On Tuesday, January 29th, the House passed, under suspension of the rules, a \$117.2 billion economic stimulus package (HR 5140: the “Recovery Rebates and Economic Stimulus for the American People Act of 2008”), which is also backed by President Bush. The vote was 385-35 with one member voting present. The package includes tax rebates for lower-income and middle-income working families in an amount equal to the lesser of their net income tax liability or \$600 (\$1,200 in the case of married couples filing a joint return). In the case of taxpayers with earned income of at least \$3,000 and taxpayers with positive income tax liability, this tax rebate will not be less than \$300 (\$600 in the case of married couples filing a joint return). The amount of the tax rebate will be increased by \$300 for each child under the age of 17. These rebates will be subject to a phase-out for taxpayers with adjusted gross income in excess of \$75,000 (\$150,000 for married couples filing jointly). The package also includes temporary provisions for small business expensing and bonus depreciation to encourage business investment in new equipment.

On the other side of Capitol Hill, Senate Finance Committee Chairman Max Baucus (D-Mont.) has unveiled a proposed economic stimulus package that would provide a flat \$500 rebate to any American with \$3000 of qualifying income to report on a 2007 tax return – including tens of millions of seniors living on Social Security. Rebates would be doubled for married couples filing jointly, and families would receive an additional \$300 per child under age 17. The Baucus plan would extend Federal unemployment insurance benefits in all states by 13 weeks, with additional benefits for workers in states with high unemployment, and would allow businesses to write off losses retroactively for as many as five years. Baucus has scheduled a mark up of his approximately \$150.5 billion package for January 30th.

Senate Majority Leader Harry Reid (D-Nev.) acknowledged the “delicate balance” in the House package that was worked out with the Administration, but has said that the Senate is not prepared to simply accept that bill. On the other hand, the Senate is far from united on what changes should be made to the House bill — Senate Democrats do not like the fact that Baucus’ package has no income cap on who will receive rebates and Senate Republicans have a problem with the increased spending for unemployment benefits. In any case, everyone expects the legislation to move forward quickly.

2. Tax Corrections Bill Signed into Law

On December 29th, President Bush signed H.R. 4839, the Tax Technical Corrections Act of 2007, into law. The act includes a significant provision to address changes to I.R.C. § 470 on sale-in, lease-out (SILO) transactions and a provision to address the treatment of losses in straddles when there are no offsetting positions with unrecognized straddle period gain or when an offsetting position is or has been a liability to the taxpayer, along with corrections to various prior acts.

COMPANY ISSUES

1. **I.R.C. § 162 – IRS Rules on Protected Cell Character and Deductibility of Premiums**

In Rev. Rul. 2008-8, 2008-5 I.R.B. ____, the IRS issued guidance on the standards for determining whether arrangements entered into with protected cells constitute insurance for federal income tax purposes and whether a protected cell is an insurance company (separate from the protected cell company that establishes the cell). The ruling describes a protected cell company (also called a “segregated account company” or “segregated portfolio company”) formed by a “sponsor” under a typical state protected cell statute, and two separate cells maintained by the cell company. The ruling states that the same principles apply to determine the insurance status of a cell arrangement as apply in determining the insurance status of an arrangement with any other issuer. That is, a single insured parent-subsidiary relationship with the cell is not insurance, while a multi-insured brother-sister relationship with a cell can be insurance.

The IRS also issued Notice 2008-19, which announces proposed guidance that would include a rule to the effect that an individual cell of a cell company would be treated as an insurance company separate from any other entity if: (a) the assets and liabilities of the cell are segregated from the assets and liabilities of any other cell and from the assets and liabilities of the cell company such that no creditor of any other cell or of the cell company may look to the assets of the cell for the satisfaction of any liabilities, including insurance claims (except to the extent that any other cell or the cell company has a direct creditor claim against such cell); and (b) based on all the facts and circumstances, the arrangements and other activities of the cell, if conducted by a corporation, would result in its being classified as an insurance company within the meaning of I.R.C. § 816(a) or 831(c). The proposed guidance also would state some of the consequences of the cell’s status as a separate insurance company, including that the cell would obtain a separate EIN, that it (not the cell company) would make tax elections (except in certain circumstances where the common parent of a consolidated group makes the election), etc. Comments on the Notice will be due 90 days after it is published in the Internal Revenue Bulletin.

2. **I.R.C. § 338 — IRS Issues Final Regulations Adopting Proposed Rules on Sale of Insurance Company Assets**

The IRS issued final regulations (T.D. 9377) that adopt rules proposed in 2006 on the deemed sale or acquisition of an insurance company’s assets under an I.R.C. § 338 election. The final rules also provide guidance under existing I.R.C. § 846(e) elections to use historical loss payment patterns. No comments were submitted regarding the proposed rules, so the IRS adopted them without substantive modification and removed the temporary regulations. The final regulations are effective as of January 23, 2008.

3. I.R.C. § 367 — Rules Are Planned to Stop Tax-Free Repatriations Using Foreign Subsidiary Asset Transfers

In Notice 2008-10, 2008-3 I.R.B. 277, the IRS announced plans to issue regulations to stop U.S. companies from using certain exceptions in I.R.C. § 367(a) to repatriate cash or other property from foreign subsidiaries without the recognition of gain or a dividend inclusion. The Notice says that the rules will clarify the exceptions to the coordination rule for I.R.C. § 368 out-bound reorganizations and I.R.C. § 351 successive transfers. The IRS explained that the Notice was issued in response to certain transactions designed to avoid U.S. income tax. Under current law, the repatriation of assets from foreign subsidiaries to domestic parent companies usually creates taxable income in the form of dividend inclusion or gain recognition. Taxpayers claim that these transactions do not result in the recognition of income because the domestic parent is able to reduce the adjusted basis in its share of a foreign affiliate by an amount equal to the realized gain. According to the Notice, “the gain realized, but not recognized, by the U.S. transferor in connection with the section 361 exchange must be preserved in the stock *received* by certain corporate shareholders.” The rules in the Notice will apply to transactions occurring on or after December 28, 2007.

4. I.R.C. § 368 — IRS Rules on Characterization of Corporate Reorganizations

In PLR 200804010 (Oct. 11, 2007), the IRS rules that the merger of acquiring and target corporations will qualify as I.R.C. § 368(a)(1)(A) reorganization, and each will be a “party to reorganization,” with no gain or loss recognized by either. In the facts of the ruling, a state mutual life insurance company that is the common parent of a life/nonlife consolidated return group proposed to acquire a target parent of a different life/nonlife consolidated return group in a statutory merger. The companies both use the reserve and accrual methods of accounting, filing calendar year tax returns, and do not have authorized capital stock. Proprietary interests are vested in member policyholders. The acquiring company will not recognize gain or loss on acquisition of the target company’s assets, and members of the target company will not recognize gain or loss on the exchange of their target proprietary interests for interests in the acquiring company. However, target members will recognize gain equal to the amount of real property transfer taxes paid by the acquiring company in connection with the merger.

5. I.R.C. § 807 — Notice re Proposed Methods for Computing Life Insurance and Variable Annuity Reserves

Notice 2008-18, 2008-5 I.R.B. ____, alerts life insurance companies to federal income tax issues that may arise as the result of the adoption of proposed Actuarial Guideline VACARVM (Proposed AG VACARVM) for variable annuity contracts and/or a proposed principles-based approach for calculating statutory reserves for life insurance contracts (Proposed Life PBR). The Notice sets forth the many tax issues that have been identified at life insurance industry tax conferences by various panels discussing the new reserving methods being proposed by the American Academy of Actuaries (AAA) and

considered by the National Association of Insurance Commissioners (NAIC). The Notice acknowledges that these proposed methods have not been adopted by the NAIC yet, but indicate that the Treasury Department and the IRS want to start considering the tax issues that arise, assuming that I.R.C. §§ 807, 816 and 7702 are not amended by Congress. Under eight general issue subheadings — Continued taxation of issuers under Part 1 of subchapter L; Qualification of contracts as life insurance contracts; Contract-by-contract versus aggregate reserves; Prevailing state assumed interest rate; Prevailing mortality tables; Transition rules: application to in-force contracts; Tax principles that override statutory accounting; and Tax administration — the Notice sets forth a variety of positions that the Treasury and the IRS might take and asks for comment. Comments should be submitted in writing on or before May 5th.

6. I.R.C. § 1221 — Court Rules that Termination Payments Were Ordinary Income

In *Trantina v. United States*, No. 05-16102 (9th Cir. 2008), the Ninth Circuit has affirmed a district court decision that payments made to an insurance agent upon termination of his agency agreement are ordinary income rather than long-term capital gains, and also that the contract under which the payments were made was not a capital asset. In the facts of the case, the insurance agent plaintiff received termination payments from his employer, an insurance company, following his retirement from the company. The plaintiff claimed that the termination payments were long term capital gain because they were made to the employee after he exchanged his shares in the company for the assets of the company during the liquidation. Additionally, the plaintiff argued that the payments were long term capital gains resulting from the sale or exchange of a capital asset (here the corporate agency agreement) held longer than one year. The court did not consider the first argument because the plaintiff had not presented that claim to the IRS. The court determined that the second claim was without merit because it found the corporate agreement was not a capital asset, but even if it were, no exchange or sale of it occurred because, per the terms of the agreement, the company retained ownership of the agreement. Because the agreement was not a capital asset in the possession of the employee, the court held that payments made according to it were properly classified as ordinary income.

7. I.R.C. § 6694 — IRS Issues Guidance Establishing “More Likely than Not” Standard for Preparers

On December 31st, the IRS released interim guidance (Notice 2008-13, 2008-3 I.R.B. 282) for tax return preparers regarding the new “more likely than not” standard for tax positions taken by their clients. Notice 2008-13 provides that the new standard will be met if the preparer has a reasonable belief that there is a greater-than-50-percent likelihood that the position will be upheld if challenged by the IRS. The Notice states that preparers may rely in good faith on information provided by the taxpayer and are not required to independently verify or review the items reported on tax returns and related documents. However, preparers may not ignore the implications of information furnished to them or actually known

to them, and must make reasonable inquiries if the information furnished appears to be incorrect or incomplete. Under the Notice, preparers will not be subject to the new penalty provisions of the law unless they purposely understate tax or act in reckless or intentional disregard of the law.

8. I.R.C. § 7701 — IRS Rules on Classification of Insurance LLC Structure

In PLR 200803004 (Oct. 15, 2007), the IRS ruled that following reorganization, type D LLC portfolios (LLC portfolios that have only a single shareholder) will be disregarded as entities separate from their owners, provided they have a single owner and do not elect to be treated otherwise. The ruling further states that, if shares in a type D portfolio are sold to one or more additional owners, the type D portfolios will be treated as a partnership. Additionally, type C LLC portfolios (LLC portfolios that elect to be treated as associations) will be classified as an association taxable as a corporation, and can make an election to be taxed as RICs after reorganization, subject to qualification for such treatment under subchapter M.

9. IRS Cancels Prior Notice on Characterization of Effective Tax Rate Reconciliation Workpapers

On December 31st, the IRS issued Chief Council Notice CC-2008-008 which cancels prior CC-2007-015, which concluded that effective tax reconciliation workpapers are neither tax accrual workpapers, nor audit workpapers under the intended definition of those categories and the IRS's longstanding policy of restraint. There was no explanation or further comment contained in the notice, however, the cancellation suggests that Chief Counsel attorneys will no longer be advising Field agents that effective tax rate reconciliation workpapers are not subject to the IRS's policy of restraint.

10. Court Finds for Government in Son of BOSS Case

In *Jade Trading LLC v. United States*, No. 03-2164T (Dec. 21, 2007), the U.S. Court of Federal Claims ruled in favor of the government. At issue in the case was whether investments of \$450,000 that generated more than \$40 million in tax losses possessed economic substance. This case is one of dozens the government is pursuing against taxpayers who refused to accept the Son of BOSS (bond option sales strategy) settlement offer. The court found that the transactions did not have economic substance because the claimed losses were "purely fictional" and because the spread transaction was developed as a tax avoidance mechanism and was not a bona fide investment strategy. In addition, the court found that the disproportionate tax advantage to the underlying monetary outlay, further indicated a lack of economic substance. The court's ruling means that the 40-percent penalty imposed by the IRS is applicable to Jade Trading. Additionally, the alternative 20-percent penalties for substantial understatement of income tax and negligence are also applicable.

11. Treasury Releases Report on Global Competitiveness

On December 20th, the Treasury Department released a report discussing three basic approaches to modernizing United States tax policy. The report is careful not to advocate any specific plan. The first option discussed would be a fundamental change from the income-based system currently in place to a business activity tax (BAT). In this system, all business entities would be taxed equally, regardless of how they are organized. The second option discussed would include several plans for reducing the corporate income tax rate to levels more competitive with other Organization for Economic Cooperation and Development (OECD) member countries. The third option discussed is a collection of tax policy changes that address “structural problems with the U.S. business tax system.” The changes would address the multiple taxation of corporate income, the tax bias toward debt finance, and the treatment of certain types of international income. According to Treasury officials, the hope is that the report will spur discussion and inform the public policy debate in these areas.

12. OECD Plans to Include Commentary on PE in Update to Model Tax Treaty

At the 20th Annual Institute on Current Issues in International Taxation on December 14th, a representative of the OECD said that it hopes to finalize a new draft commentary on existing Article 7 of the Model Tax Treaty in time to be included in the 2008 update to the model. In December 2006, the OECD published a final version of Parts I, II, and III of its *Report on the Attribution of Profits to Permanent Establishments*. Part IV of the report, which deals with insurance, is the final piece of the report. The draft of Part IV was published in August, 2007, followed up with a consultation and meetings of the OECD working group. According to the OECD representative, there is agreement in principle on what the text will say and hope that the text will be finalized in the next few months.

13. FASB Working on Guidance for Unearned Premium Revenue

The Financial Accounting Standards Board (FASB), as part of continued redeliberations on how to account for financial guarantee insurance contracts, indicated that it is also having discussions related to unearned premium revenue, hoping to create accounting guidance that would be sustainable over time and would make allowance where there are pools of assets. The FASB said that the use of prepayment assumptions would be permitted to determine an expected term, specifically where there are pools of assets or obligations where prepayments are probable and reliably estimable. The board also said that adjustments for subsequent changes in those prepayment assumptions would be on a prospective basis. Additional information is available from the FASB website at http://www.fasb.org/project/financial_guarantee_insurance.shtml.

14. Court Rules that IRS Violated U.K.-U.S. Tax Treaty

In *National Westminster Bank PLC v. United States*, No. 2007-5028 (Jan. 15, 2008), the U.S. Court of Appeals for the Federal Circuit ruled that the IRS's use of Treas. Reg. § 1882-5 and the corporate yardstick to allocate interest expense in the case violated the 1975 U.K.-U.S. tax treaty. The plaintiff, National Westminster Bank (NatWest), brought a refund action against the United States in 1995, seeking a refund in connection to interest expense deduction calculation for interest paid on interbranch transactions between 1981 and 1987. The IRS disallowed the deduction based on rules found in Treas. Reg. § 1.882-5 and recalculated the bank's taxable income, concluding that additional taxes were owed. The bank paid the additional taxes, but filed suit alleging that the IRS's actions were in violation of Article 24 of the U.K.-U.S. tax treaty. The Court of Federal Claims agreed with NatWest and ruled in its favor. The Court of Appeals affirmed the lower court's ruling, holding that the treaty does not allow for attribution of additional capital to the branch based on hypothetical infusions of capital. It further affirmed the lower court's reasoning that determination of a branch's business profits is comparable to that of a separately incorporated U.S. subsidiary, meaning that intracorporate transactions are not disregarded but are adjusted to reflect arm's-length terms.

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