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TAX ISSUES SUMMARY

February 29, 2008

***HIGHLIGHT*:**

I.R.C. § 162 — New Rule Regarding Performance-Based Compensation Plans under Section 162(m) Is Made Prospective

On February 21, the IRS released Rev. Rul. 2008-13, 2008-10 I.R.B. ___ in a tacit acknowledgment that PLR 200804004 (Sept. 21, 2007), which was released at the end of January, was a marked departure from prior rulings by the IRS on what is covered by the exception for performance-based compensation under I.R.C. § 162(m)(4)(C). Although its holdings are consistent with PLR 200804004, pursuant to I.R.C. § 7805(b)(8), Rev. Rul. 2008-13 provides that it will not be applied to disallow a deduction for any compensation that otherwise satisfies the requirements for qualified performance-based compensation under I.R.C. § 162(m)(4)(C) and Treas. Reg. § 1.162-27(e)(2), and that has payment terms similar to those described in the ruling if either (1) the performance period for such compensation begins on or before January 1, 2009, or (2) the compensation is paid pursuant to the terms of an employment contract as in effect (without renewals) on February 1, 2008. *See* Company Issues.

LEGISLATION

1. Stimulus Package — Tax Writers Are Busy from the Start of the Second Session

When Congress returned for its second session, tax writers on both sides of Capitol Hill immediately jumped into the drafting and passage of an economic stimulus package, which was signed by President Bush on February 13th. The centerpiece of the stimulus package is $105 billion in rebate checks to be sent out to low and moderate income households. In addition, there is $45 billion in temporary incentives for businesses to make new investments in capital equipment. With the stimulus package completed, tax writers have turned their attention again to the tax portion of the energy and farm bills, both of which the Administration has threatened to veto should they contain any revenue-raising provisions.

Because of the Democrats' narrow margin in the Senate, discussions on the 2009 budget resolution have also included what tax provisions might be included for purposes of this year's budget reconciliation. Likely candidates for budget reconciliation are a $35 billion package of tax incentives to reduce the cost of education and encourage production of renewable forms of energy, as well as extensions of some three dozen expiring tax cuts ("expiring provisions") and another one-year "patch" for the alternative minimum tax (AMT).

2. Administration's 2009 Budget Proposals

On February 4, President Bush released a $3.1 trillion budget proposal for 2009 that would make permanent, the tax cuts of 2001 and 2003, and that appears to balance the budget by 2012 (assuming that the AMT is in full effect). The proposed budget called for a $145 billion economic stimulus package (which now has been enacted) and an extension of AMT relief for 2008, though it did not suggest how to pay for either proposal. Some additional proposals include expanded tax-exempt qualified mortgage bonds, extending dozens of expired or expiring tax incentives, and making permanent certain charitable giving provisions. In addition, the Administration proposes a change to the disclosure standard for tax return preparers, that is, that they be confident that they have "substantial authority" (not more likely than not) when taking a position not disclosed on a return.

POLICYHOLDER ISSUES

1. I.R.C. § 101 — Request for Ruling on Death Benefits and QAB Rider Withdrawn

The IRS released a memorandum, CCA 200805022 (Aug. 17, 2007), which was written to the IRS field in connection with a taxpayer's withdrawal of a request for guidance on whether the change in the death benefit from a fixed amount at risk, plus cash value to a fixed death benefit or the addition of a qualified additional benefit (QAB) rider would cause the contracts to lose their grandfather treatment. The contracts involved were a pre-1985 life contract which could become subject to I.R.C. § 7702 and a pre-TAMRA (Technical and Miscellaneous Revenue Act of 1988) life contract which could become subject to the reasonable mortality charge rules. The IRS memorandum informs the IRS field that it had concluded that the proposed changes would cause a loss of the grandfather treatment and that I.R.C. § 7702 would apply to the contracts.

2. I.R.C. § 402 — IRS Rules Long-Term Care Insurance Benefits Currently Taxable

In PLR 200806013 (Nov. 15, 2007), the IRS ruled that a participant who elects to have long-term care insurance benefits under a qualified profit-sharing plan will be currently taxable on the cost of the insurance under I.R.C. § 402(a). The ruling also states that the distribution of insurance premiums to pay the coverage costs may jeopardize the continued qualified status of the plan under I.R.C. § 401(a).

COMPANY ISSUES

1. I.R.C. § 162 — New Rule Regarding Performance-Based Compensation Plans under Section 162(m) Is Made Prospective

On February 21, the IRS released Rev. Rul. 2008-13, 2008-10 I.R.B. ___ in a tacit acknowledgment that PLR 200804004 (Sept. 21, 2007), which was released at the end of January, was a marked departure from prior rulings by the IRS on what is covered by the exception for performance-based compensation under I.R.C. § 162(m)(4)(C). Although its holdings are consistent with PLR 200804004, pursuant to I.R.C. § 7805(b)(8), Rev. Rul. 2008-13 provides that it will not be applied to disallow a deduction for any compensation that otherwise satisfies the requirements for qualified performance-based compensation under I.R.C. § 162(m)(4)(C) and Treas. Reg. § 1.162-27(e)(2), and that has payment terms similar to those described in the ruling if either (1) the performance period for such compensation begins on or before January 1, 2009, or (2) the compensation is paid pursuant to the terms of an employment contract as in effect (without renewals) on February 1, 2008. Rev. Rul. 2008-13 concludes that payment of an anticipated "performance-based" award upon termination "without cause" or "for good reason," or upon voluntary retirement, is not remuneration payable solely on account of the attainment of one or more performance goals. Accordingly, Rev. Rul. 2008-13 holds that the awards are not qualified performance-based compensation under I.R.C. § 162(m)(4)(C) and Treas. Reg. § 1.162-27(e)(2).

2. I.R.C. §§ 197 and 338 — Final Regulations Issued on Assumption Reinsurance Transactions and Reserve Increases After Deemed Asset Sale

The Treasury published final regulations in the Federal Register on January 23 relating to the application of I.R.C. § 338 to insurance companies. The final regulations (T.D. 9377) remove temporary regulations contained in T.D. 9257, which went into effect in 2002, and made the corresponding proposed regulations permanent.

3. I.R.C. § 501 — Organization's Tax Exempt Status Revoked

In TAM 200807018 (Feb. 15, 2008), the IRS revoked the exempt status of an organization for a particular tax year because it did not operate as an I.R.C. § 501(c)(15) insurance company. Considering the facts of the case, the IRS concluded that the policies written by the company to cover third-party environmental liability on storage tanks did not constitute insurance because they lacked risk distribution.

4. I.R.C. § 807(f) — Appeals Settlement Position Paper on Change in Basis for Reserves

On February 14th, the IRS posted a coordinated issue settlement position paper from the Appeals Division on its website which says that changes in life insurance company reserve items must be treated as a change in basis subject to a 10-year spread, except for when the change is due to a correction of a nonrecurring mathematical or posting error. The Appeals position is identical to that of the Examination Division and is based on the plain language of I.R.C. § 807(f), according to the paper. Though the position paper was only recently published online, the position has been effective since March 2001.

5. I.R.C. § 882 — Court Rules in IRS's Favor in *Swallows Holding* Case

In *Swallows Holding, Ltd. v. Commissioner*, Doc. No. 02-08045 (3d Cir. February 15, 2008), the Third Circuit overturned the Tax Court's decision that a tax return filing regulation was invalid. In the facts of the case, Swallows Holding, Ltd., a Barbados corporation, held real property in California. The corporation's owners were Mexican nationals. Between 1993 and 1996, the corporation earned rental income from the property, though its expenses exceeded its income each year. Under I.R.C. § 882, a foreign corporation such as Swallows Holding is taxed on income connected with the conduct of that business. Deductions are allowed only if they are connected with the "income which is effectively connected with the conduct of a trade or business within the United States." The corporation failed to file tax returns for the years 1993 through 1996 until 1999 when it claimed the deduction effectively connected with the U.S. business. The IRS disallowed the claimed deductions because the U.S. returns were not filed within 18 months of the due date as required by Treas. Reg. § 1.882(c)(2). The corporation challenged the disallowance, and the Tax Court ruled that, because I.R.C. § 882(c)(2) did not include a timely filing requirement, the deductions should have been allowed. The Third Circuit disagreed, reasoning that the 18-month filing window found in Treas. Reg. § 1.882-4(a)(3)(i) was a reasonable exercise of the Treasury's authority. The Third Circuit further opined that the Tax Court erred by not applying the proper standard of deference to the Treasury regulations.

6. I.R.C. § 1502 — Proposed Consolidated Returns Regulations Partially Withdrawn

A hearing scheduled for February 29th on proposed consolidated returns regulations under Treas. Reg. § 1.1502-13 was cancelled, and the proposed regulation's section 1.1502-13(e) has been withdrawn, apparently in response to industry comments regarding how the rule would be applied for insurance and reinsurance transactions between members of an insurance companies consolidated group. For example, the ACLI had requested in its comment letter on the proposed regulations that this section addressing the treatment of insurance transactions between members of a consolidated group be withdrawn or modified to clarify that insurance transactions involving the insurance or reinsurance of third-party risks would continue to be treated as they are under the current rules.

7. Government Argues Court Should Reverse *Textron* Workpapers Ruling

On January 25th, the government filed a brief asking the U.S. Court of Appeals for the First Circuit to overturn the decision made last summer denying a government petition to get tax-accrual workpapers from a financial services subsidiary of Textron Inc. *United States v. Textron*, Doc. No. 07-2631 (1st Cir. January 25, 2008). Previously, the District Court for the District of Rhode Island found that the documents requested were protected by the work product privilege. The district court found that the IRS did not demonstrate a substantial need for ordinary work products, and thus did not meet the heightened burden that would be applicable to the tax-accrual workpapers. In the appeal, the government asks the First Circuit to consider (1) whether the tax-accrual workpapers at issue are protected from disclosure by the work-product doctrine, and if so, whether disclosure of that information to an independent auditor waives that protection; (2) whether the lower court erred in concluding that Textron met the requirements for invoking attorney-client privilege and tax practitioner-client privilege, even

though the court ultimately determined those privileges were waived; and (3) whether the lower court erred in not enforcing the summons to the extent that it requested tax-accrual workpapers prepared by the independent auditor.

8. CRS Releases an Updated Report on Catastrophic Insurance Reserve Funds

On January 31st, the Congressional Research Service (CRS) released an updated report detailing proposals to allow insurance firms to establish a tax-deductible reserve fund for catastrophes. The report comes as new studies suggest that climate change is likely to bring about more intense and frequent natural disasters. Currently, insurers are discouraged from accumulating funds to cover potential future major disasters, allowing deductions only for disasters that already have occurred. Of concern is whether there is enough catastrophe insurance in the market to handle a major natural disaster without widespread insolvencies and the inability of insurance companies to honor insured losses. The National Association of Insurance Commissioners (NAIC) developed a proposal similar to legislation introduced in Congress that addresses this issue. The NAIC proposal would make tax-deferred reserves mandatory. Critics of catastrophe fund proposals argue that there is considerable uncertainty as to whether the theoretical reasons for establishing catastrophe reserves are likely to come to pass. Because of that uncertainty, the CRS advised proceeding with caution.

***IRS Circular 230 Disclosure*:**

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