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## TAX ISSUES SUMMARY

March 28, 2008

### ***HIGHLIGHTS:***

#### **I.R.C. §§ 72 and 1035 — Guidance on Partial Exchanges of Annuity Contracts**

The IRS has issued Rev. Proc. 2008-24, 2008-13 I.R.B. \_\_\_\_, which supersedes Notice 2003-51, 2003-2 C.B. 361, and provides guidance on partial exchanges. The procedure provides that partial exchanges of an annuity contract will be treated as tax free if (1) no amounts are withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 12 months beginning on the date on which amounts are treated as received as premiums or other consideration paid for the contract received in the exchange (the date of the transfer); and/or (2) the taxpayer demonstrates that one of the conditions described by I.R.C. § 72(q)(2)(A), (B), (C), (E), (F), (G), (H), or (J), or any similar life event (such as divorce or loss of employment), occurred between (i) the date of the transfer, and (ii) the date of the withdrawal or surrender. *See* Policyholder Issues.

#### **I.R.C. § 817 — Regulations Issued on Diversification Requirements for Variable Contracts**

The IRS has issued regulations (T.D. 9385) on the I.R.C. § 817(h) diversification requirements affecting insurance companies that issue variable contracts and the policyholders who buy the contracts. Because the regulations remove a provision that said that the payment required to remedy an inadvertent diversification failure must be based on the tax that would have been owed by the policyholders if they were treated as receiving the income on the insurance contract, the IRS is no longer blocked from providing alternative toll charge calculations for closing agreement procedures to fix inadvertent diversification failures. *See* Company Issues.

## LEGISLATION

### **In General — Legislative Activity in March Focuses on the Budget**

After the hectic activity to produce an economic stimulus package, March Congressional activity focused on the budget, with the House approving its budget resolution on March 13th and the Senate approving its resolution on March 14th. H. Con. Res. 312 would offset a one-year alternative minimum tax (AMT) patch with reconciliation instructions and set aside deficit-neutral reserve funds for estate tax and long-term AMT reform, and also includes education and alternative energy incentives and extensions of middle-income tax relief. S. Con. Res. 70 contains a major tax amendment that would make middle-income tax breaks, and the scheduled 2009 estate tax rate and exemption levels, permanent; that would enact a standard property tax deduction for non-itemizers and increase the credit for adoption and child care. Notably, the Senate budget resolution does not include an AMT patch. The House and Senate will now proceed with a conference toward achieving a non-binding resolution for handling the 2009 budget matters.

Other than working toward a combined budget resolution, legislative activities involving tax have been somewhat slow. The House passed the Pension Protection Technical Corrections Act, and there have been ongoing negotiations on the Farm bill and on an Energy bill. At the end of February, the JCT released its technical explanation of the revenue provisions of the Renewable Energy and Energy Conservation Tax Act of 2008, which proposes a modification to corporate estimate tax payments as a revenue offset.

## POLICYHOLDER ISSUES

### **1. I.R.C. §§ 72 and 1035 — Guidance on Partial Exchanges of Annuity Contracts**

The IRS has issued Rev. Proc. 2008-24, 2008-13 I.R.B. \_\_\_\_, which provides guidance on partial exchanges. The procedure, which supersedes Notice 2003-51, 2003-2 C.B. 361, states that partial exchanges of an annuity contract will be treated as tax free if (1) no amounts are withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 12 months beginning on the date on which amounts are treated as received as premiums or other consideration paid for the contract received in the exchange (the date of the transfer); and/or (2) the taxpayer demonstrates that one of the conditions described by I.R.C. § 72(q)(2)(A), (B), (C), (E), (F), (G), (H), or (J), or any similar life event (such as divorce or loss of employment), occurred between (i) the date of the transfer, and (ii) the date of the withdrawal or surrender. Note that the revenue procedure reduces the period within which surrenders or withdrawals are presumed to be for tax avoidance from 24 months to 12 months, without distinguishing between inter-company and intra-company partial exchanges. In addition, the procedure does not include the subjective requirement of Notice 2003-51 that surrenders or distributions from the existing annuity contracts not have been contemplated at the time of the partial exchange.

**2. I.R.C. § 408 — Division of a Trust-Held IRA into Multiple Separate IRAs for Trust Beneficiaries Is Not a Taxable Distribution**

In PLR 200809042 (Feb 29, 2008), the IRS ruled that an individual retirement account (IRA) belonging to a deceased individual, which passed into an irrevocable trust, may be subdivided through a trustee-to-trustee transfer into separate IRAs created in the name of the deceased individual for the benefit of each of the irrevocable trust's beneficiaries. The IRS ruled that creating such separate IRAs will not result in a taxable distribution.

**COMPANY ISSUES**

**1. I.R.C. §§ 197 and 338 — IRS Corrects Final Regulations on Sale, Acquisition of Insurance Business**

The IRS has issued a clarifying correction to final regulations T.D. 9377 on determining the adjusted basis of amortizable I.R.C. § 197 intangibles for insurance contracts, increases in reserves after a deemed asset sale, and the effect of a I.R.C. § 338 election to use a company's historical loss payment pattern. The correction is effective as of March 18, 2008.

**2. I.R.C. § 446 — IRS Offers Safe Harbor Accounting Method for FICA and FUTA Payroll Tax Liabilities**

On March 11th, the IRS released Rev. Prov. 2008-25, 2008-13 I.R.B. \_\_\_ (Mar. 11, 2008), which offers a safe harbor method of accounting to taxpayers who use an accrual method for payroll tax liabilities. The procedure also allows taxpayers to obtain automatic consent of the Commissioner to change to the safe harbor method. The new provision applies to taxpayers who incur tax liabilities for compensation, including bonuses and vacation pay, under the Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA). The IRS said that confusion had arisen about the proper accrual of FICA and FUTA tax liabilities, and that this guidance is meant to clarify treatment of these liabilities. The safe harbor can be elected by an accrual method taxpayer that uses the "recurring item" exception under Treas. Reg. § 1.461-5 for its payroll tax liabilities. The procedure is effective for taxable years ending on or after Dec. 31, 2007, and the service will not challenge a taxpayer's use of the safe harbor method of accounting on a federal income tax return filed before March 11, 2008, so long as the taxpayer meets the requirements of the revenue procedure in that taxable year.

**3. I.R.C. § 501(c)(15) — Insurance Companies Lose Their Exempt Status**

In PLR 200809034 (Mar. 27, 2007), the IRS revoked the I.R.C. § 501(c)(15) exempt status of a captive company, concluding that the company did not meet the operational requirements of an insurance company because the sole shareholder of the company was the only customer insured party. The IRS stated that the arrangement found in this organization did not constitute insurance because there is not

adequate risk distribution. The IRS further stated that the organization did not meet the criteria for an I.R.C. § 501(c)(15) organization because the “insurance” activities of the company are insignificant in comparison to the income derived from investments.

In TAM 200809045 (Nov. 2, 2007), the IRS concluded that a reinsurance company did not qualify for I.R.C. § 501(c)(15) exempt status despite a previously issued determination letter allowing the company to claim tax-exempt status. The TAM revokes that exempt status because the premium income received by the company for its insurance activities comprised only approximately one fourth of its total income, and because the company did not attempt to increase its insurance business activities. For these reasons, the IRS concluded that the company was not primarily engaged in insurance activities (i.e., not an insurance company) for the years in question, which were after the determination letter was issued.

#### **4. I.R.C. § 501(c)(15) — Insurance Company in Receivership Still Qualifies for Exempt Status**

In PLR 200810031 (Dec. 12, 2007), the IRS ruled that an insolvent insurance company in receivership qualifies for the transition rule under the Pension Funding Equity Act, and its tax-exempt status will remain intact. A provision in section 206 of the Act says that if an insurance company meets the requirements of I.R.C. § 501(c)(15)(A), as in effect for the last taxable year beginning before January 1, 2004, and is in a receivership, liquidation, or similar proceeding, then the Act’s amendments made by that section will only apply to taxable years beginning after the earlier of the date such proceeding ends or December 31, 2007. In this case, the IRS determined that the company did meet the requirements of the transition rule and, therefore, will retain its I.R.C. § 501(c)(15) exempt status for all distributions made prior to December 31, 2007.

#### **5. I.R.C. § 817 — Regulations Issued on Diversification Requirements for Variable Contracts**

The IRS has issued regulations (T.D. 9385) on the I.R.C. § 817(h) diversification requirements affecting insurance companies that issue variable contracts and the policyholders who buy the contracts. The final regulations adopt proposed regulations (REG-118719-07), with just one modification. In response to a comment received, the final regulations clarify that the separate accounts segregated under Puerto Rican law that are now included in the list of permitted investors for purposes of the look-through rule do not have to meet the general I.R.C. § 817(d)(1) requirement of segregation under State law and regulations. The regulations remove a provision that said that the payment required to remedy an inadvertent diversification failure must be based on the tax that would have been owed by the policyholders if they were treated as receiving the income on the insurance contract. This last change will allow the IRS to provide alternative toll charge calculations for closing agreement procedures to fix inadvertent diversification failures.

**6. I.R.C. § 817 — IRS Extends Time for RICs to Comply with Prior Rulings**

In PLRs 200811013 (Oct. 16, 2007) and 200811014 (Oct. 16, 2007), the IRS granted requested modifications to PLRs 200730004 (Apr. 27, 2007) and 200730005 (Apr. 27, 2007), which held that regulated investment companies (RICs) may qualify for lookthrough treatment under Treas. Reg. § 1.817-5(f), where beneficial interests in the RICs are held by pension and retirement plans. The prior rulings had conditioned being able to qualify for this treatment on coming into compliance within 180 days. The RICs indicated that they had complied with the condition on most of the plans, but not all. The IRS extended the time for compliance to 270 days to allow the RICs more time to fulfill the conditions of the original rulings.

**7. I.R.C. § 831 — IRS Rules Extended Service Agreements Qualify as Insurance**

In PLR 200811009 (Nov. 5, 2007), the IRS ruled that certain extended service agreements qualify as insurance contracts for federal tax purposes, and the taxpayer will be considered an insurance company under I.R.C. § 831(a), so long as at least half of its business consists of issuing such agreements.

**8. I.R.C. § 4371 — IRS Announces Voluntary Compliance Program for Foreign Insurers**

On March 7th, the IRS issued Announcement 2008-18, 2008-12 I.R.B. 667, and Rev. Rul. 2008-15, 2008-12 I.R.B. 633, which provide a voluntary compliance initiative aimed at encouraging foreign insurance companies who have failed to pay excise taxes due under I.R.C. § 4371 to come into compliance. The announcement describes the program and specifies to whom it will apply, specifically foreign insurers, reinsurers, and other agents, solicitors, and brokers. The revenue ruling clarifies the consequences under I.R.C. §§ 4371 and 4374 when premiums are paid by one foreign insurer or reinsurer to another foreign reinsurer, including the situation in which the first insurer or reinsurer qualifies for an exemption from the excise tax under an income tax treaty with the United States and the second does not. The IRS said in the ruling that, if a taxpayer participates in the voluntary compliance program, the IRS generally will not conduct examinations covering insurance excise tax liabilities arising under the four situations set forth in the ruling “to the extent that premiums are paid or received by the participating taxpayer during any quarterly tax period prior to Oct. 1, 2008.”

**9. I.R.C. § 6041 — For Information Reporting Purposes, Payor May Assume that Compensatory Damage Payments Are Excludable from Gross Income**

In CCA 200809001 (Nov. 27, 2007), the IRS Office of Chief Counsel recommended that the IRS not assert that information reporting is required under I.R.C. § 6041 with respect to compensatory damages paid by an entity to settle certain old tort claims stemming from alleged physical injury and emotional distress. The IRS concluded that it is reasonable to presume that such payments are for personal physical injury and emotional distress attributable to physical injury and, thus, excluded from gross income for federal tax purposes. This presumption was acceptable because the passage of time and

the fact that the claimant was a minor when the tort occurred made it difficult to establish the extent of the physical injuries. Additionally, the IRS noted that any portion of damages allocable to punitive damages (as opposed to compensatory damages) or interest would be includable in the claimant's gross income, and the payor of the punitive damages must issue a Form 1099 if the aggregate payments during the calendar year are in excess of \$600.

***IRS Circular 230 Disclosure:***

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