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TAX ISSUES SUMMARY

April 30, 2008

HIGHLIGHTS:

I.R.C. § 812 — Audit Directive on Separate Account DRD Released

An audit Directive (LMSB-04-0308-010) was released on April 22, 2008, by the LMSB Industry Director, Financial Services, to provide agents guidance in the examination of the dividends-received deduction (DRD) incurred in connection with separate accounts of life insurance companies. The Directive refers to the issuance of Rev. Rul. 2007-54 and the fact that it was suspended by Rev. Rul. 2007-61. It says that the audit techniques discussed therein may assist the agent in determining whether the rate used by a particular taxpayer in computing the required interest under § 812 is, in fact, PSAIR or AFR, and suggests IDR questions that may be asked. *See* Company Issues.

IRS and Treasury Ask for Recommendations on Items to Be Included on the 2008-2009 Guidance Priority List

In Notice 2008-47, 2008-18 I.R.B. ____, the IRS invites recommendations on items that should appear on the 2008-2009 Guidance Priority List. Recommendations for inclusions on the list should be received by May 31, 2008. *See* Company Issues.

IRS and Treasury Release the First Update of the 2007-2008 Priority Guidance Plan

On April 22, 2008, the IRS and the Treasury unveiled the first periodic update of the 2007-2008 Priority Guidance Plan. With respect to insurance company and product issues, the updated Plan indicates that three items on the original Plan have not yet been addressed and that six new items in the insurance area have been added. The updated 2007-2008 Priority Guidance Plan includes as an additional item: "9. Guidance concerning insurance company reserves under section 812 for variable contracts," and refers to the publication of both Rev. Rul. 2007-54 and Rev. Rul. 2007-61 as guidance already published addressing the subject. It otherwise does not mention the regulations project on I.R.C. § 812 proration for variable contracts that Rev. Rul. 2007-61 stated had been added to the 2007-2008 Priority Guidance Plan. *See* Company Issues.

LEGISLATION

1. In General — House and Senate Tax Writers Continue Working but Nothing Final Is Passed

House and Senate tax conferees on the Farm bill (H.R. 2419) reached an agreement in principle last Friday, accommodating the Administration's objections by dropping the cost basis reporting by stock brokers. With another short extension of farm reauthorization, there is general hope that the Farm bill will be completed next month. Meanwhile, wrangling over the budget continues, whether to require offsets for the alternative minimum tax (AMT) patch for another year or whether to take the AMT patch out of any reconciliation instructions altogether.

In mid-April, Senate Finance Committee Chairman Max Baucus (D-Mont.) announced that the Finance Committee will have a series of hearings on tax code reform this spring in order to be ready with a tax reform bill when the next president takes office, noting that several current tax laws are set to expire in 2010; new legislation will be needed to prevent tax law from "swing[ing] back to the pre-2001 law." Also in mid-April, Senators Baucus and Charles Grassley (R-Iowa) introduced legislation that would extend approximately three dozen expiring tax breaks as well as provide a new exemption increase for the AMT, which would prevent it from affecting more than 20 million new taxpayers. The bill did not include any mention of offsets to pay for the extenders.

In mid-April, under threat of a White House veto, the House passed the Taxpayer Assistance and Simplification Act of 2008 (H.R. 5719), which would repeal the IRS's authority to enter into private debt collection contracts, and would require participants in health savings accounts (HSAs) to document any spending out of the HSA by showing that it is health related. And, the Senate easily passed legislation (H.R. 3221) intended to help reduce home foreclosures and support the housing sector through new tax incentives, providing more than \$18 billion for extending certain energy tax credits and providing aid to home owners in the Gulf Coast region that were affected by the 2005 hurricanes; the Senate version does not include the net operating loss (NOL) carryback extension provision that was central in the Senate's prior tax package.

2. Small Business Health Insurance Coverage Legislation Introduced

In early April, Senators Richard Durbin (D-Ill.), Olympia Snowe (R-Maine), Blanche Lincoln (D-Ark.), and Norm Coleman (R-Minn.) introduced legislation (S. 2795) that would help small businesses offer health insurance to their workers, by allowing small businesses to join risk pools to lower employee premiums, provide tax credits to help businesses and self-employed individuals afford coverage, and make insurance ratings based on health status and claim experience by insurers illegal.

POLICYHOLDER ISSUES

1. I.R.C. §§ 101 and 264 — IRS Issues Guidance on Split-Dollar Life Insurance Modifications

In Notice 2008-42, 2008-15 I.R.B. ____, the IRS issued guidance that provides that a modification of a split-dollar life insurance arrangement that does not entail any change to the life insurance contract underlying the arrangement will not be treated as a material change in the life insurance contract for purposes of I.R.C. § 101(j) or § 264(f). While both sections apply to “life insurance contracts,” the notice clarifies that the term does not generally encompass the terms of a split-dollar insurance arrangement, of which the contract is a part. According to the notice, if the parties to a split-dollar life insurance arrangement modify the terms of the arrangement, but do not modify the terms of the contract underlying the arrangement, the modification will not be treated as a material change in the life insurance contract for purposes of those sections. This is true even if the modification is treated as a material modification of the split-dollar arrangement under the regulations governing those arrangements.

2. I.R.C. § 104 — Supreme Court Declines to Hear an Appeal of the *Murphy* Case

On April 21, 2008, the United States Supreme Court declined to hear an appeal of *Murphy v. Internal Revenue Service*, 493 F.3d 170 (D.C. Cir. 2007), in which the U.S. Court of Appeals for the District of Columbia Circuit reversed its previous conclusion that I.R.C. § 104(a)(2), as limited to physical injuries, was unconstitutional. The Circuit Court ultimately held that compensatory damages awarded for emotional distress and injury to professional reputation were taxable. Murphy’s attorney released a statement saying that he was not surprised that the Supreme Court denied certiorari, because there is not a traditional split among the circuits on this issue. He indicated that he expects other circuits will address this issue in the future.

COMPANY ISSUES

1. I.R.C. § 807 — IRS Issues Interest Rates for Computing Insurance Reserves

In Rev. Rul. 2008-19, 2008-13 I.R.B. 699, the IRS provides the applicable Federal rates and prevailing State interest rates for insurance companies to use in computing reserves under I.R.C. § 807(d)(2) for contracts issued in 2007 and 2008. Under I.R.C. § 807(d)(2), insurance companies must calculate life insurance reserves using the higher of the applicable Federal interest rate or the prevailing State assumed interest rate. This ruling supplements State interest rate schedules provided in Rev. Rul. 92-19, 1992-1 C.B. 227.

2. I.R.C. § 812 — Audit Directive on Separate Account DRD Released

An audit Directive (LMSB-04-0308-010) was released on April 22, 2008, by the LMSB Industry Director, Financial Services, to provide agents guidance in the examination of the dividends-received deduction (DRD) incurred in connection with separate accounts of life insurance companies. The Directive is intended to provide planning guidance and audit techniques to ensure consistent audit

treatment. The Directive states that “[c]orrect determination of the amount of dividends subject to DRD would ensure that a Life Insurance company does not realize double benefits by deducting part of investment earnings credited to the policyholders that have already been deducted through the increase in reserves.” The Directive refers to the issuance of Rev. Rul. 2007-54 and the fact that it was suspended by Rev. Rul. 2007-61 because the issues considered therein would more appropriately be addressed by regulations. The Directive says that the DRD on separate accounts of life insurance companies is not a mandatory examination item, but should be considered in the auditor’s risk analysis; then, if risk analysis indicates that the issue is material, it should be developed. The Directive further says that “[a]lthough this issue may be raised under existing Code provisions (i.e. §§ 807 and 812(b)(2)), agents may not apply Revenue Ruling 2007-54, which has been suspended.”

In its general discussion of the law, the Directive states that “[u]nder § 812(b)(2), required interest on reserves generally is determined using the greater of the prevailing State assumed interest rate (PSAIR) or the applicable Federal interest rate (AFR) if such rate is used in determining reserves for the contract. See § 812(b)(2)(A); Rev. Rul. 2003-120;[sic] 2003-2 C.B. 1154.” It then goes on to say that “[t]he audit techniques discussed below may assist the agent in determining whether the rate used by a particular taxpayer in computing the required interest under § 812 is, in fact, PSAIR or AFR.” The Directive suggests that four IDR questions be asked, presumably to help the agent to determine whether the PSAIR or the AFR was used in computing required interest. Depending on the answers to the first IDR questions, the Directive suggests an additional IDR question. The Directive does not mention that “another appropriate rate” also can be used for purposes of required interest, nor does it suggest an IDR question regarding the amount of potential double benefit (i.e., the increase in reserves allowed the company).

3. I.R.C. § 848 — IRS Rules on DAC Tax Consequences of Assumption Reinsurance as Part of a Rehabilitation

In PLR 200814005 (Dec. 27, 2007), the IRS considered federal DAC tax consequences under I.R.C. § 848 of a proposed reinsurance transaction involving two life insurance companies, the ceding company being a mutual life insurance company in rehabilitation and the assuming company being a domestic stock life insurance company. The transaction arose as part of a rehabilitation plan and would involve a transfer by assumption reinsurance of the ceding company’s life insurance and other contracts to the assuming company. The IRS determined that the ceding company qualifies an insolvent insurance company within the meaning of Treas. Reg. § 1.848-2(i)(4)(v) and that, assuming that the ceding company has net negative consideration which results in an excess negative capitalization amount under Treas. Reg. § 1.848-2(i) as a result of the assumption reinsurance agreement, the ceding company and the assuming company are eligible to make the joint election set forth in Treas. Reg. § 1.848-2(i)(4) with respect to the assumption reinsurance agreement. Such an election allows the ceding company to forgo a carryover of a part of its excess negative capitalization amount attributable to the agreement and allows the assuming company to reduce its specified policy acquisition expenses for that year by the amount of the ceding company’s excess negative capitalization amount that is not carried over.

4. I.R.C. § 1502 — Proposed Rules on Treatment of Consolidated Group Insurance Transactions Withdrawn

Announcement 2008-25, 2008-14 I.R.B. 732, was released by the IRS on April 3, 2008, and formally withdrew a portion of a notice of proposed rulemaking (REG-107592-00). The withdrawn portion related to the treatment of transactions involving the provision of insurance between members of a consolidated group. *See* Company Issues in the *Tax Issues Summary* for February, 2008.

5. I.R.C. § 3121 — IRS Determines Insurance Agents' Rights to Renewal Commissions are Non-Qualified Deferred Compensation Plans

In CCA 200813042 (Dec. 17, 2007), the IRS concluded that insurance agents' rights to renewal commissions under a corporation's commission plan constitute nonqualified deferred compensation plans under I.R.C. § 3121(v)(2). The advice also concluded that the agents' rights to any renewal commissions, because they would not be paid if the policies are not renewed or if customers do not pay renewal premiums, were subject to a substantial risk of forfeiture. Accordingly, because the renewal commissions were subject to a substantial risk of forfeiture, the insurance company was not permitted to take the nonqualified deferred compensation into account for purposes of I.R.C. § 3121(v)(2) in the year the services are performed; the IRS should deny the insurance company's refund claims for FICA withheld and paid when the renewal commissions were paid.

6. I.R.C. § 7701 — With a Partnership, Who Is the Insured Entity Depends on the Form of Partnership

In TAM 200816029 (Dec. 3, 2007), the IRS considered whether a partner or the partnership should be considered the insured entity under a purported insurance arrangement for purposes of evaluating if sufficient risk distribution exists to treat the arrangement as insurance. In the facts considered in the memorandum, one member of an affiliated group provides insurance coverage to the other affiliates, which include some entities organized as limited partnerships. The IRS noted that, in the context of limited partnerships, the general partner is exposed to liability greater than the partnership assets and, therefore, it is appropriate to view the general partner as the insured entity. If a partnership does not have a general partner, the IRS said that the partnership should be considered the insured entity under liability coverage for purposes of determining whether the arrangement constitutes insurance for federal income tax purposes.

7. IRS and Treasury Ask for Recommendations on Items to Be Included on the 2008-2009 Guidance Priority List

In Notice 2008-47, 2008-18 I.R.B. ____, the IRS invites recommendations on items that should appear on the 2008-2009 Guidance Priority List. In reviewing recommendations and selecting projects for inclusion on the 2008-2009 Guidance Priority List, the Treasury Department and the IRS will consider the following: (1) whether the recommended guidance resolves significant issues relevant to many taxpayers; (2) whether the guidance may be appropriate for enhanced public involvement through the process described in Notice 2007-17, 2007-12 I.R.B. 748; (3) whether the recommended guidance promotes sound tax administration; (4) whether the recommended guidance can be drafted in a manner

that will enable taxpayers to easily understand and apply the guidance; (5) whether the IRS can administer the recommended guidance on a uniform basis; and (6) whether the recommended guidance reduces controversy and lessens the burden on taxpayers or the IRS. Recommendations for inclusions on the list should be received by May 31, 2008.

8. IRS and Treasury Release the First Update of the 2007-2008 Priority Guidance Plan

On April 22, 2008, the IRS and the Treasury unveiled the first periodic update of the 2007-2008 Priority Guidance Plan. Updated plans, generally, provide the IRS and Treasury with flexibility to consider input from taxpayers and tax practitioners throughout the year; the updated Plan just released includes 61 pieces of additional guidance that have been added since the original Plan was released last August. With respect to the insurance company and product issues, the updated Plan indicates that three items on the original Plan have not yet been addressed: (1) the final regulations on the exchange of property for an annuity contract; (2) a revenue ruling concerning the meaning of the term “statutory reserves” under I.R.C. § 807, addressing situations where the insurance company is subject to different statutory reserve requirements in different states; and (3) guidance regarding remediation procedures for life insurance and annuity contracts based on comments received on Notice 2007-15. The updated Plan includes six additional items in the insurance area, five of which refer to guidance projects that were accomplished and/or addressed during the last year even though the project had not been on the original Plan. There is one additional item that is in the updated Plan that is not yet addressed and that is “Guidance on business-owned life insurance pursuant to section 101(j).”

The updated 2007-2008 Priority Guidance Plan includes as an additional item: “9. Guidance concerning insurance company reserves under section 812 for variable contracts,” and refers to the publication of both Rev. Rul. 2007-54 and Rev. Rul. 2007-61 as guidance already published addressing the subject. Although the updated Plan does not mention specifically the regulations project on I.R.C. § 812 proration for variable contracts that Rev. Rul. 2007-61 stated had been added to the 2007-2008 Priority Guidance Plan, item 9 could be read generally as including that regulations project.

9. Court Rules that Title Insurers May Not Recover Erroneously Collected Estate Taxes

In *First American Title Insurance Co. v. United States*, No. 05-35520 (9th Cir. March 27, 2008), a U.S. Court of Appeals concluded that a lower court had lacked jurisdiction to decide title insurers’ claims where the insurers attempted to recover federal estate taxes erroneously or illegally assessed and collected. In the facts of the case, the personal representative of an estate consisting of three houses and stock filed a federal estate tax return on behalf of the estate. The estate elected to pay the estate tax on an installment plan. The personal representative conveyed the houses to herself and her husband, and then sold the houses to three separate buyers over the course of the next two years. Although title searches were conducted as part of the sales, the plaintiff title insurance companies did not discover the houses were encumbered by tax liens. When the IRS audited the estate, it found that the stock was worth more than the estate had valued it at. The personal representative worked out a compromise with the IRS on a value for the stock that increased the estate taxes. When the corporation that issued the stock filed for bankruptcy, the personal representative stopped paying estate taxes. The owners of the homes sold by

the personal representative made title insurance claims, which the insurers paid. The title insurers then brought a case under I.R.C. § 1346 to recover the federal estate tax. The district court concluded that it lacked jurisdiction to decide the claims and denied leave to amend to join the personal representative as a plaintiff, as the amendment would not make a difference to the finding. On appeal, the court agreed with the district court and found that I.R.C. § 7426 was the sole remedy available to the plaintiffs, because I.R.C. § 1346 does not provide a means under which a third party can sue. The court also said that the title insurers were not permitted under I.R.C. § 7426 to challenge the assessment the IRS made for the value of the stock, which is why the title insurers moved to add the personal representative as a plaintiff. I.R.C. § 6402(a) only allows a refund to be made to the person who made the overpayment, which the personal representative did not do. For that reason, the court denied the motion to join the personal representative to the suit.

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For comments or questions, or if you would like to receive the Tax Issues Summary via electronic mail, please contact Katherine L. Berland at (202) 434-9169 or kberland@scribnerhall.com Scribner, Hall & Thompson, LLP, website: www.scribnerhall.com