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## TAX ISSUES SUMMARY

May 30, 2008

### **HIGHLIGHTS:**

#### **I.R.C. § 72 — IRS Rules Nonqualified Life Annuity Contract Is Immediate Annuity**

In PLR 200818018 (Jan. 29, 2008), the IRS ruled that a variable life annuity contract that starts payouts within a year of issuance, using first one method for making substantially equal periodic payments for one phase and then another method for the second phase, constitutes an immediate annuity within the meaning of I.R.C. § 72(4)(u). *See* Policyholder Issues.

#### **I.R.C. § 6112 — IRS Issues Guidance on Material Advisor Reporting**

In Rev. Proc. 2008-20, 2008-20 I.R.B. \_\_\_\_, the IRS offers guidance on a material adviser's obligation to prepare and maintain lists for reportable transactions. The procedure allows a material adviser to use a form made available online by the IRS to maintain the itemized statement component of the list under I.R.C. § 6112. Form 13976, titled "Itemized Statement Component of Advisee List," is designed to simplify the method of list maintenance required of material advisers. *See* Company Issues.

## LEGISLATION

### **1. Congress Works on Multiple Targeted Tax Packages**

Amidst continued debate on what role taxes should have in the 2009 budget, both houses of Congress did succeed in passing a Farm bill (H.R. 2419) by veto proof margins and send it to the President, who vetoed the bill, which both houses then overrode. Despite that success, there was a problem; the bill that was enrolled and then vetoed by the President was missing one of the fifteen titles that had been passed by Congress. The House has already started the process over, voting on and

passing again the Farm bill as it was intended, sending it to the Senate for passage, so it can then be enrolled properly, presumably to be vetoed again, for another vote to override the veto. Presumably, practice will make it perfect.

In addition to the Farm bill, both houses of Congress passed the Heroes Earning Assistance and Relief Tax (HEART) Act (H.R. 6081) which would extend or modify several tax benefits for active-duty and former military service members including permanently exempting veterans who served on active duty from the first-time home-buyer requirement for qualified mortgage bonds, permanently extending the treatment of combat pay as earned income for EITC purposes, allowing service members filing joint returns to claim an economic stimulus tax rebate regardless of whether their spouses have Social Security numbers, and extending the limitations period for veterans to file tax refund credit claims for service related disability benefits. The military tax provisions are fully offset by revenue to be raised from treating foreign government contractors that are subsidiaries of U.S.-based companies as domestic companies for tax purposes (collecting payroll taxes) and from changes in the tax required to be paid upon a U.S. entity expatriating, as well as from an increase in the general failure-to-file penalty for tax returns. The bill has been sent to the President, but the Bush Administration has not expressed a view of the bill yet.

## **2. House Passes Extenders and Energy Bill Despite White House Veto Threat**

On May 21, the House passed a \$54 billion package of tax extenders and energy incentives, despite the threat of a veto coming from the White House. The Renewable Energy and Jobs Creation Act (H.R. 6049), contains one-year extensions of tax provisions that expired at the end of 2007 or are set to expire after 2008. These “extenders” include the research credit, the state and local sales tax deduction, and the tuition deduction, but do not include a patch for the AMT. The bill also offers tax incentives for renewable energy. The package is fully offset, with some offsets coming from taxes on offshore deferred compensation and a delay until 2019 of implementation of the worldwide interest allocation benefit. The House bill is considered to be one which the Senate can “work with.” However, regardless of whether the House and Senate might agree, it is not clear that the threatened veto can be overridden.

## **3. War Supplemental Bill Includes Tax Provisions**

On May 15, the House passed an amendment to a 2008 war supplemental spending bill. The bill would increase veterans’ education benefits and would pay for the cost of such increased benefits with a 0.47% surtax on modified adjusted gross income of individuals earning more than \$500,000 annually and couples earning more than \$1 million. Again, the President has said he would veto such a bill because of the tax increase.

## **POLICYHOLDER ISSUES**

### **1. I.R.C. § 72 — IRS Rules Nonqualified Life Annuity Contract Is Immediate Annuity**

In PLR 200818018 (Jan. 29, 2008), the IRS ruled that a variable life annuity contract under which periodic payments start within a year of issuance and are computed using an annuity unit method or actuarial equivalent constitutes an immediate annuity under I.R.C. § 72(u)(4). In the facts of the ruling, a stock life insurance company proposed to issue single-premium nonqualified life annuity contracts available as either immediate variable annuities or deferred variable annuities, each of which would have two payout phases. During the first payout phase, the contract owner can surrender the contract and the periodic payout amounts are based on the account value; during the second payout phase, the periodic payout amounts are based on the annuity unit approach traditionally used for variable annuities. The method for computing the payouts during the first phase is one of those recognized as providing substantially equal periodic payments for purposes of avoiding the 10-percent penalty on early withdrawals under I.R.C. § 72(q) and (t). The IRS concluded that the company's method of computing the periodic payments to be made during each of the two phases, either the annuity unit method or its actuarial equivalent, would provide substantially equal periodic payments. Because of this, the IRS ruled that a contract that starts payouts within a year of issuance, using first one method for making substantially equal periodic payments for one phase and then another method for the second phase, constitutes an immediate annuity within the meaning of I.R.C. § 72(4)(u).

### **2. I.R.C. § 72 — IRS Addresses Impact of Policy Value Credits**

In PLR 200820009 (Jan. 31, 2008), the IRS supplements PLR 200814005 (Dec. 27, 2007), which examined a transaction involving two life insurance companies where one's contracts were transferred to the other via assumption reinsurance under a state court's supervision. The prior ruling addressed Subchapter L and related annuity and insurance questions. The new ruling considers endorsements that the ceding mutual insurance company will add to its policies, which provide that contracts held in/as qualified plans will be authorized to receive compensation for the extinguishment of mutual membership interests in the form of credits to the policy values rather than cash. The IRS ruled that the investment in the contract under I.R.C. § 72 for each endorsed contract immediately after assumption will remain the same as an unendorsed contract immediately prior to endorsement. Neither the addition of a credit nor the right thereto constitutes a distribution in violation of I.R.C. §§ 403(a), 402(b)(11) or 408(e), and that the addition of the credit to a non-trusted retirement funding account does not constitute a distribution nor a contribution and, thus, will not result in gross income to the employee or other beneficiary of such contract prior to actual receipt.

### **3. Tax Court Finds Annuity Agreements Are Capital Expenditures**

In *Perano v. Commissioner*, T.C. No. 5543-06, 130 T.C. No. 8 (May 7, 2008), the Tax Court ruled that transactions giving rise to private annuity agreements constituted capital expenditures by a controlled foreign corporation (CFC). The court further held that because the company's accruals under the agreements constituted reserves for future contingencies, they did not reduce its earnings or profits. In the facts of the case, American General, Ltd., a CFC, received real property and notes secured by real

property from the Peranos. The property and notes were transferred in exchange for private annuity agreements that provided for the future payment of monthly annuities to the Peranos for their remaining joint lives. From the period between 1994 and 2001, the company accrued liabilities related to those agreements that exceeded income and also exceeded accumulated earnings and profits as of December 31, 2001. The Peranos treated the accruals as I.R.C. § 953 life insurance reserves for tax purposes, and so did not report income from American General for 2001 under I.R.C. § 951(a)(1). The Peranos conceded that American General is not an insurance company, but claimed that did not matter. The court noted that, in addition to failing to prove the company was an insurance company, the couple also failed to prove that the company realized any insurance income in connection to the annuity agreements. The court held that the Peranos did not properly report their 2001 income.

## COMPANY ISSUES

### 1. I.R.C. § 358 — IRS Issues Final Regulations on Assumption of Liabilities in Tax-Free Restructurings

The IRS has released final regulations (T.D. 9397) which address basis adjustment for the assumption of liabilities under I.R.C. § 358(h) when property is transferred in exchange for stock in incorporations and certain reorganizations. Prior to enactment of I.R.C. § 358(h), taxpayers failed to reduce stock basis for liabilities assumed to generate immediate deductions on sale of the stock. The final regulations removed temporary regulations (T.D. 9207) that were issued in May 2005 and finalized proposed regulations (REG-0106736-00) without making any changes to them. Thus, to prevent abusive basis transactions, the final regulations adopt the position of the 2005 rules to eliminate the exception for cases where substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange. The final rules have an effective date of May 9, 2008.

### 2. I.R.C. § 368 — IRS Rules that Reverse Subsidiary Taxable Merger, Followed by Target Liquidation, Does Not Qualify as Tax-Free Reorganization

In Rev. Rul. 2008-25, 2008-21 I.R.B. \_\_\_\_, the IRS ruled that a multi-step transaction in which the stock of a target corporation is acquired in a taxable reverse subsidiary merger, followed by the liquidation of the target into the acquiring corporation, does not qualify under the “step-transaction doctrine” as a reorganization under I.R.C. § 368(a). The IRS indicated that, in deciding if this type of transaction is a reorganization, it must apply the approach found in Rev. Ruls. 67-274 and 2001-26, which ignores the acquirer’s acquisition of the target stock in the acquisition merger and treats the transaction as a direct acquisition of the target’s assets by the acquirer in exchange for cash and voting stock and assumption of the target’s liabilities. The IRS distinguished the facts in this ruling from the earlier ones, saying that the direct acquisition of the target’s assets in this case does not qualify as a I.R.C. § 368(a) reorganization (because of the cash). Therefore, the IRS treated the acquisition of the target stock as a qualified stock purchase under I.R.C. § 338, followed by a tax-free liquidation of the target under I.R.C. § 332.

**3. I.R.C. § 368 — IRS Issues Final Safe-Harbor Rules on Post-Reorganization Transactions**

The IRS has released final rules (T.D. 9396) which amend prior guidance (T.D. 9361) on transfers of assets or stock following a tax-free corporate reorganization under I.R.C. § 368(a). The rules adopt safe harbors for when the step-transaction doctrine will not be applied to cause a reorganization to fail to satisfy I.R.C. § 368 when the reorganization is followed by a transfer or distribution of assets or stock. However, the rules deny safe harbor protection in many cases where transfers are made to former shareholders in consideration for a proprietary interest in the acquired or surviving corporation.

**4. I.R.C. § 6112 — IRS Issues Guidance on Material Advisor Reporting**

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**5. I.R.C. § 7874 — IRS Issues Final Regulations on Corporate Inversions**

The IRS has issued final regulations (T.D. 9399) on the taxation of corporate inversions and the application of unfavorable tax treatment prescribed by I.R.C. § 7874 when certain conditions are met. A corporate inversion occurs when a U.S. company effectively reincorporates offshore by merging into a foreign surrogate. The regulations maintain the computational rules introduced in prior temporary regulations for determining the scope of the inverted company's expanded affiliated group of subsidiaries. The final regulations do not carve out a specific exception for preferred shares, causing some critics to view the regulations as overly broad. The IRS and Treasury have indicated that they are aware that some taxpayers may attempt to avoid the application of I.R.C. § 7874 by structuring the inversion of a U.S. entity into a foreign entity through the use of intervening partnerships, resulting in an ownership fraction of zero; disagreeing with this interpretation of I.R.C. § 7874, they are considering promulgating additional regulations to clarify the proper application of the rules when partnership interests are involved.

**6. Judge Quashes IRS Summons for Workpapers**

In *Regions Financial Corp. v. United States*, N.D. Ala., No. 2:06-cv-00895-RDP (May 8, 2008), a judge for the U.S. District Court for the Northern District of Alabama quashed an IRS summons seeking tax accrual workpapers and other documents that Regions Financial Corp. turned over to its accounting firm during a financial audit. The judge cited the recent *Textron* decision, where the U.S. District Court for the District of Rhode Island applied the "because of litigation" test and held that tax accrual workpapers were protected under the work product privilege. The judge in the *Regions* case also found that the documents were protected under the "primary motivating purpose" test, which protects

documents created primarily in connection with possible future litigation. After the court's ruling, Donald Korb, IRS Chief Counsel, said that the IRS will continue to take the position that tax accrual workpapers are not prepared for litigation despite the *Regions* case.

#### **7. Retaliatory Tax on Foreign Title Insurance Companies Upheld**

In *First American Title Insurance Co. v. Combs*, No. 05-0541 (Tex. May 16, 2008), the Texas Supreme Court upheld the retaliatory tax applied by Texas to out-of-state title insurance companies. The state imposes the tax on foreign title insurers if the insurer's home states impose more burdensome taxes, fees, and other obligations on Texas title insurers selling insurance there than Texas imposes on foreign title insurers selling insurance in Texas. The purpose of the retaliatory taxes, as explained in the court ruling, is to promote interstate business of domestic insurers by deterring other states from enacting discriminatory or excessive taxes against foreign insurance companies. The court ultimately found that the retaliatory tax scheme in Texas equalized the tax burdens borne by title insurers in a way that rationally related to a legitimate state purpose, and therefore should be upheld.

#### **8. FASB Clarifies Accounting for Financial Guarantee Insurance Contracts**

On May 23, the Financial Accounting Standards Board (FASB) issued Statement No. 163, Accounting for Financial Guarantee Insurance Contracts, which clarifies how FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, applies to financial guarantee insurance contracts issued by insurance companies. A FASB project manager said that the guidance was issued to address concerns about the financial health of financial guarantee insurers. The changes under the new statement are aimed at getting consistency among companies with respect to the recognition and measurement of premium revenue and claim liabilities. The premium revenue recognition approach links premium revenue recognition to the amount of insurance protection (i.e., the insured principal amount outstanding) and to the period of coverage; the recognition approach for claim liabilities requires that an insurance company recognize a claim liability when the company expects a claim loss to exceed the unearned premium revenue. The claim liability is to be measured as the present value of expected net cash outflows, discounted at a risk-free rate, with the net cash flows being probability weighted to reflect all possible outcomes for payments under the contract. The statement may be accessed at <http://www.fasb.org/pdf/fas163.pdf>.

#### **9. IRS Official Says Insurance Issues Likely to Fall Under Tier III List of Issues**

At an insurance tax panel earlier this month, Nancy Vozar Knapp, associate area counsel in the IRS Office of Chief Counsel, said that narrow tax issues, such as those regarding life insurance, would most likely fall on the Tier III list, as long as the issues do not cross industries and are not considered high tax compliance risks. The LMSB has not yet released its list of Tier III issues, and Knapp said she did not know of a definitive time frame for completing that list.

## 10. IRS Official Offers Advice on Workpaper Requests

At the Federal Bar Association Annual Insurance Tax Seminar held on May 22, deputy director of prefilling and technical guidance in the LMSB Lori Nichols said that, if a taxpayer believes that an agent's request for tax accrual workpapers is inappropriate or inapplicable, the taxpayer should contact the case manager or supervisor. She also said that a transaction's classification as a Tier I issue will not necessarily trigger an IRS request for tax accrual workpapers.

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