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TAX ISSUES SUMMARY

June 27, 2008

HIGHLIGHTS:

I.R.C. § 897 — IRS Rules Real Estate Swaps Are Not Real Property Interests

In Rev. Rul. 2008-31, 2008-26 I.R.B. ____, the IRS ruled that interests in a notional principal contract (NPC) whose return is calculated on a broad-based U.S. real estate index will not be considered U.S. real property interests for purposes of I.R.C. § 897(c)(1). *See Company Issues.*

Tax Court Rules that Insurance Company Must Calculate AMT Adjustment Amounts on a Consolidated Basis

In *State Farm Mut. Auto. Ins. Co. v. Commissioner*, No. 5426-05 (June 23, 2008), the Tax Court held that the common parent of an affiliated group comprised of life and non-life insurance companies must compute its adjusted current earnings (ACE) and ACE adjustment on a consolidated basis for the entire consolidated group, rather than for subgroups, and must apply the loss limitation rules to its pre-adjustment AMT income when calculating its ACE, ACE adjustment, and post-ACE adjustment AMT income. *See Company Issues.*

LEGISLATION

In General

Efforts of tax writers in both the House and the Senate to finish several tax projects before the July 4th recess look to be unsuccessful. Despite an overwhelming approval for cloture on the Housing bill (H.R. 3221), the Senate is still stalled on considering amendments. Earlier in the month, the Senate tried twice and failed twice to get cloture for consideration of the House-passed bill (H.R. 6049) that

would extend expired and expiring provisions — those opposed to the consideration object to the fact that the House bill's revenue cost is fully offset, saying that Congress should not have to raise taxes to pay for extending "current law." Meanwhile, unfazed by a veto threat, the House has proceeded to pass an AMT patch, which is fully offset by new tax provisions, including taxing carried interest earned by hedge fund managers as compensation, cracking down on treaty shopping of U.S. subsidiaries of foreign firms and limiting or eliminating the I.R.C. § 199 manufacturing deduction for oil and gas producers (all tax provisions opposed by the Administration). Given the Senate's record on the general extenders bill, no one expects the AMT patch to be paid for when it comes up for a vote in the Senate.

On the other hand, the President did sign the Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008, and both the House and the Senate for a second time overrode the President's second veto of the Farm Bill (H.R. 6124).

POLICYHOLDER ISSUES

1. I.R.C. § 72 — IRS Clarifies Rules on IRA Rollovers to HSA

In Notice 2008-51, 2008-25 I.R.B. 1163, the IRS notified taxpayers that it will permit distributions from IRAs or Roth IRAs to a health savings account (HSA). The IRS clarified that a qualified HSA distribution may be made only from a traditional or ROTH IRA, not from an ongoing SIMPLE IRA or an ongoing SEP IRA. Generally, the qualified HSA funding distribution is a one-time transfer from an individual's IRA to his or her HSA, excluded from gross income and not subject to the 10 percent additional tax under I.R.C. § 72(t). However, if the distribution occurs when the individual has self-only high deductible health plan (HDHP) coverage, and later in the same taxable year the individual has family HDHP coverage, the individual is permitted another qualified HSA funding distribution in that taxable year. Both distributions, nevertheless, would count against the individual's maximum HSA contribution for that taxable year. If an individual owns more than two IRAs and wants to transfer amounts from both into the HSA, he or she must first make an IRA-to-IRA transfer into a single IRA, and then make the one-time qualified HSA funding distribution from that single IRA.

In order to reap the tax advantages, an individual making the transfer must remain eligible during the entire "testing period." The "testing period" commences with the month in which the qualified HSA funding distribution is contributed to a HSA and ends on the last day of the 12th month following such month. If at any point during the testing period the individual is ineligible, the amount of the qualified HSA funding distribution is included in the individual's gross income. Note that employers are not responsible for reporting whether an employee remains an eligible individual during the testing period.

2. I.R.C. § 223 — IRS Issues Guidance on HSA Contributions

The IRS has issued Notice 2008-52, 2008-25 I.R.B. 1166, providing guidance on contributions to HSAs. Specifically, the guidance notes the repeal of the limit on annual HSA contributions based on the amount of the deductible under the HDHP for 2007 and thereafter. The Notice describes the method for calculating an individual's annual maximum HSA contributions for 2007 and later years. From 2004 through 2006, the maximum annual HSA contribution was the lesser of (1) the annual deductible under the high deductible health plan (HDHP) or (2) the statutory maximum under I.R.C. § 223(b)(2)(B). For 2007 and later years, the indexed maximum HSA contribution under I.R.C. § 223(b)(2)(A) (for self-only HDHP coverage) determines the contribution limit, without regard to an individual's HDHP deductible. To illustrate, for 2008 the maximum annual HSA contribution is \$2,900 for individuals who have self-only HDHP coverage and \$5,800 for individuals who have family HDHP coverage.

If an individual, however, is not considered an eligible individual on the first day of the last month of the individual's tax year, then the maximum contribution for the year is determined under the sum of the monthly contribution limits rule under I.R.C. § 223(b)(2). Under that rule, annual contribution limits take into account monthly limits based on eligibility and health plan coverage on the first day of the month. The full contribution rules allows individuals who are eligible on the first day of the last month of the tax year as having been eligible for the entire year and may increase, but not decrease, the contribution limit for such an individual. Additionally, the guidance explains the consequences for individuals who fail to remain eligible during the testing period and describes the imposition of the I.R.C. § 4973 excise tax on excess contributions. According to the guidance, employers are not responsible for reporting whether an employee remains an eligible individual during the testing period.

The IRS also issued Notice 2008-59, which provides 40 questions and answers regarding HSA eligibility and funding.

COMPANY ISSUES

1. I.R.C. § 501(c)(15) — Organizations Lose Tax-Exempt Insurance Company Status

In TAM 200824028 (Nov. 15, 2005), the IRS concluded that an organization is not eligible to be a tax-exempt insurance company as described in I.R.C. § 501(c)(15) because its primary activity is investment, not insurance. After being given a tax-exemption determination letter, the company's potential liability for unpaid losses decreased and its assets rose. The organization's investment activities included purchasing assets unrelated to insurance and ownership of an entity from which it received income. Furthermore, the organization did not develop or market its insurance services, had no employees, and did not write new policies. In the memorandum, the IRS also revoked the organization's I.R.C. § 953(d) election to be treated as a domestic corporation and ruled that, because the organization was unqualified for relief under I.R.C. § 7805(b), it could not rely on its determination letter.

In TAM 200824029 (Nov. 15, 2005), the IRS concluded that an organization failed to qualify as a tax-exempt insurance company as described in I.R.C. § 501(c)(15) because, during the tax years at issue, the organization did not operate as a runoff insurance company, which is a company that no longer writes new business. The organization's assets and surplus increased without a corresponding rise in the proportion of its loss reserves and the organization did not attempt to close the business or develop new business. The IRS likewise revoked the organization's section 953(d) election to be treated as a domestic corporation and concluded that, because the organization was unqualified for relief under section 7805(b), it could not rely on its determination letter.

2. I.R.C. § 501(c)(15) — Insurance Company Eligible for Tax-Exempt Status Is Not Required to Accept Such Status

In PLR 200824024 (Mar. 20, 2008), the IRS ruled that an insolvent corporation, even if eligible, was not required to file as an insurance company exempt from federal income tax under I.R.C. § 501(c)(15). The ruling notes that the company was in receivership, liquidation, or similar proceeding under the supervision of a State court as of the relevant date. The ruling also noted that the company's net written premium income for the time period at issue did not exceed \$350,000. As such, the transition rule of The Pension Funding Equity Act of 2004 would operate in such a way to include the company in the exemption under I.R.C. § 501(c)(15). The IRS mentioned that though the insolvent corporation never before filed an Application for Recognition of Exemption or a Return of an Organization Exempt from Income tax. A company eligible for tax-exemption is not required to file as such.

3. I.R.C. § 897 — IRS Rules Real Estate Swaps Are Not Real Property Interests

In Rev. Rul. 2008-31, 2008-26 I.R.B. ____, the IRS ruled that interests in a notional principal contract (NPC) whose return is calculated on a broad-based U.S. real estate index will not be considered U.S. real property interests for purposes of I.R.C. § 897(c)(1). In the facts of the ruling, a foreign corporation entered into a NPC with a U.S. corporation. Under the terms of the contract, the foreign corporation would receive the value of real estate appreciation in a given U.S. geographical market as measured by a third party's index for the area. If the market suffered a depreciation, the foreign corporation would suffer a loss. The IRS noted that "[b]ecause of the broad-based nature of the Index, an investor cannot, as a practical matter, directly or indirectly, own or lease a material percentage of the real estate, the values of which are reflected by the Index." The ruling also states that the issuer of the NPC does not, directly or indirectly, own or lease a material percentage of the real property, the value of which is reflected by the Index. Under I.R.C. § 897(a), a foreign corporation's gain or loss from the disposition of a U.S. real property interest (USRPI) is treated as effectively connected income under I.R.C. § 871(b)(1) or 882(a)(1), as though the taxpayer were engaged in a U.S. trade or business during the tax year and the gain or loss were effectively connected with that trade or business. I.R.C. § 897(c)(1)(A) defines a USRPI as being an interest in real property located in the United States or the U.S. Virgin Islands, or any interest in a domestic corporation that holds real property. The IRS ruled that, because the broad-based nature of the Index, the NPC does not represent a direct or indirect right to share in the appreciation in value of the real property; it therefore is not a USRPI for purposes of I.R.C. § 897(c)(1).

4. I.R.C. §§ 6694 and 6695 — IRS Issues Proposed Regulations on Return Preparer Penalty Provisions

The IRS has issued proposed regulations (REG-129243-07) which implement amendments to the tax return preparer penalties under I.R.C. §§ 6694 and 6695 made by the Small Business and Work Opportunity Tax Act of 2007. The proposed regulations allow the IRS to assess penalties against either the tax return preparer who signed the return or a nonsigning tax return preparer who has supervisory responsibility for a position giving rise to an understatement. This new “preparer-per-position” rule is different than the current “one preparer per firm” rule that is in the current regulations.

The proposed regulations also provide guidance on the method for determining income derived from the return preparation when computing the penalty amount under I.R.C. § 6694. Additional guidance on how to meet “reasonable belief” standard is provided in the regulations — that is, if, after conducting an analysis on the pertinent facts and authorities, a tax return preparer reasonably concludes in good faith that the position has a greater than 50 percent likelihood of being sustained on its merits. Also, the proposed regulations provide the rules for disclosure of a position for which there is a reasonable basis, but for which the preparer does not meet the more-likely-than-not standard.

The IRS is soliciting comments on the proposed regulations, due by August 18. Discussion topic outlines for the public hearing to be held August 18 are due by August 4. The IRS specifically invites comments on the examples given in the regulations, and to suggest new examples that should be included in the final regulations.

5. Tax Court Rules that Insurance Company Must Calculate AMT Adjustment Amounts on a Consolidated Basis

In *State Farm Mut. Auto. Ins. Co. v. Commissioner*, No. 5426-05 (June 23, 2008), the Tax Court held that the common parent of an affiliated group comprised of life and non-life insurance companies must compute its adjusted current earnings (ACE) and ACE adjustment on a consolidated basis. The court also held that the company must use pre-adjustment alternative minimum taxable (AMT) income to calculate its ACE and ACE adjustment. In the facts of the case, the taxpayer filed consolidated returns for the years involved. The IRS issued deficiency notices for four tax years. The taxpayer then recalculated its ACE for AMT income purposes, creating alternative tax net operating losses that could be carried back to prior years. The court, relying on its reasoning in a prior related case, reasoned that the book income adjustment in *State Farm Mut. Auto. Ins. Co. v. Commissioner*, 119 T.C. 342 (2002) (*State Farm I*) is similar to the ACE adjustment in the present case. *State Farm I* held that a single adjustment for a life-/non-life insurance consolidated group is the correct method for figuring an

alternative minimum tax book income adjustment. The court noted that the taxpayer must calculate its ACE and ACE adjustment on a consolidated basis for the entire consolidated group, rather than for subgroups, and must apply the loss limitation rules to its pre-adjustment AMT income when calculating its ACE, ACE adjustment, and post-ACE adjustment AMT income.

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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