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## TAX ISSUES SUMMARY

August 26, 2008

### **HIGHLIGHTS:**

#### **I.R.C. §§ 61 and 72 — Court Applies Open-Transaction Doctrine to Proceeds from Sale of Stock Acquired in Demutualization**

In *Fisher v. United States* (Fed. Cl., No. 94-1726T), the U.S. Court of Federal Claims on August 6, 2008, found the value of the ownership rights of stock acquired during the demutualization of a life insurance company is not discernable and, therefore, the irrevocable trust to which the stock had been issued did not realize any income on the sale of the stock in question because the sale proceeds were less than the cost basis of the insurance policy that gave rise to the stock issuance. *See* Policyholder Issue.

#### **I.R.C. § 446 — New Revenue Procedure for Automatic Accounting Method Changes**

On August 18, 2008, the IRS issued Revenue Procedure 2008-57, 2008-36 I.R.B. \_\_\_, which updates guidance on accounting method changes for which taxpayers can get automatic consent from the Commissioner of Internal Revenue, Rev. Proc. 2002-9, 2002-1 C.B. 327, by consolidating in several automatic consent procedures published subsequent to Rev. Proc. 2002-9 and by adding automatic accounting change procedures for areas previously not covered. *See* Company Issues.

## LEGISLATION

### **In General**

Congress recessed for the month of August over the objections of several Republicans who wanted to continue to debate energy issues. With all eyes on, first the Olympics, then the Democratic and Republican nominating conventions, little is happening on Capital Hill. Many assume that the House and Senate will try to move the package of extender tax provisions when they return after Labor Day, but activity on any other tax legislation looks doubtful.

Senator Ben Nelson (D-NE) is proposing a bill that would amend the current Internal Revenue Code to provide Treasury with authority to waive penalties for failure to disclose reportable transactions (such as 412(i) plans) as long as the nondisclosure was due to reasonable cause. Reportedly, Nelson hopes this amendment can be added to the tax extenders legislation, even though that has not happened so far.

## **POLICYHOLDER ISSUE**

### **I.R.C. §§ 61 and 72 — Court Applies Open-Transaction Doctrine to Proceeds from Sale of Stock Acquired in Demutualization**

In *Fisher v. United States* (Fed. Cl., No. 94-1726T), the U.S. Court of Federal Claims on August 6, 2008, found the value of the ownership rights of stock acquired during the demutualization of a life insurance company is not discernable and, therefore, the irrevocable trust to which the stock had been issued did not realize any income on the sale of the stock in question because the sale proceeds were less than the cost basis of the insurance policy that gave rise to the stock issuance.

At trial, both parties' expert witnesses assigned different values to the stock ownership rights. On one hand, the trust's expert claimed that he could not assign the fair market value of the rights because they were inextricably tied to the policy; the ownership rights added value to the policy but never had a separate value. The government's expert, on the other hand, claimed that the fair market value of the ownership rights was zero; none of the premiums were specifically dedicated to acquiring the ownership rights and, at the time the policy was acquired, it was highly unlikely that a demutualization would occur. The judge did not give credit to the government's argument and found that the trust did not realize any income on the sale of the stock in question because it had not recovered the cost basis of the policy. The judge also explained that the case should not be seen as a "revivification" of the open transaction doctrine; instead, the decision is driven by unique facts.

## **COMPANY ISSUES**

### **1. I.R.C. § 446 — New Revenue Procedure for Automatic Accounting Method Changes**

On August 18, 2008, the IRS issued Revenue Procedure 2008-57, 2008-36 I.R.B. \_\_\_, which updates guidance on accounting method changes for which taxpayers can get automatic consent from the Commissioner of Internal Revenue, Rev. Proc. 2002-9, 2002-1 C.B. 327, by consolidating in several automatic consent procedures published subsequent to Rev. Proc. 2002-9 and by adding automatic accounting change procedures for areas previously not covered. The new areas of coverage deal with credit card annual fees, late fees, advance fees, and advance payments. The procedure recognizes that a method of accounting change under I.R.C. § 446 may be made with an I.R.C. § 481(a) adjustment or using a cut-off basis.

The procedure notes that the IRS may impose “any otherwise applicable penalty, addition to the tax, or additional amount for the failure of a taxpayer to change its method of accounting,” if the taxpayer does not file a timely request and that the taxpayer’s return preparer may also be subject to the preparer penalty under I.R.C. § 6694. Penalties, however, will not be imposed when a taxpayer changes from an impermissible method of accounting to a permissible one. A taxpayer under examination may use the automatic change procedure if the issue has not been raised in the examination and the taxpayer is within one of the open “windows.” If a taxpayer under examination, on the other hand, is not eligible to change a method of accounting under this revenue procedure, the change may be made by the director.

Areas of interest to insurance companies for which automatic changes are allowed under Rev. Proc. 2008-52 include :

- capital expenditures under I.R.C. § 163;
- losses, expenses, expenses and interest with respect to transactions between related taxpayers under I.R.C. § 267;
- deferred compensation under I.R.C. § 404;
- methods of accounting under I.R.C. § 446;
- taxable year of deduction under tax code I.R.C. § 461;
- mark to market accounting method for dealers in securities under tax code I.R.C. § 475;
- insurance company premium acquisitions under tax code I.R.C. § 832;
- discounted unpaid losses under tax code I.R.C. § 846;
- income from sources within the United States under I.R.C. § 861;
- original issue discount under I.R.C. §§ 1272 and 1273;
- market discount bonds under I.R.C. § 1278; and
- short-term obligations under I.R.C. § 1281.

## **2. I.R.C. § 501(c)(15) — Insolvent Insurance Company Satisfies Transition Rule to Be Tax- Exempt**

In PLR 200831028 (May 5, 2008), the IRS concludes that a non-life insurance company in receivership fulfilled the requirements of the transition rule for insolvent insurance companies under section 206(e)(2) of the Pension Equity Funding Act of 2006 to qualify as tax exempt through 2007. Thus, the company will not suffer any adverse tax consequences under I.R.C. § 501(c)(15) with regard to the receiver’s final distribution to creditors and closing of the estate. The 2006 amendments to I.R.C. § 501(c)(15) do not apply to insolvent insurance companies until taxable years beginning after the earlier of the date insurance company’s liquidation ends or December 31, 2007.

## **3. I.R.C. § 842 — Domestic Asset/Liability Percentages for Foreign Life Insurers Released**

In Rev. Proc. 2008-53, 2008- I.R.B. \_\_, the IRS provides the domestic asset/liability percentages and domestic investment yields needed by foreign life insurance companies and foreign property and liability insurance companies to compute their minimum effectively connected net investment income under I.R.C. § 842(b) for tax years beginning after December 31, 2006. For the first

taxable year beginning after December 31, 2006, the relevant domestic asset/liability percentages are (a) 124.4 percent for foreign life insurance companies, and (b) 197.1 percent for foreign property and liability insurance companies. For the first taxable year beginning after December 31, 2006, the relevant domestic investment yields are (a) 4.9 percent for foreign life insurance companies, and (b) 4.2 percent for foreign property and liability insurance companies.

The general guidance dealing with the computation of the amount of net investment income to be included by a foreign insurance company on its U.S. income tax return is in Notice 89-96, 1989-2 C.B. 417. For the domestic asset/liability percentage and domestic investment yield, as well as instructions for computing foreign insurance companies' liabilities for estimated tax and installment payments of estimated tax for taxable years beginning after December 31, 2005, *see* Rev. Proc. 2007-58, 2007-37 I.R.B. 585.

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