

SCRIBNER, HALL & THOMPSON, LLP

SUITE 1050

1875 EYE STREET, N. W.

WASHINGTON, D. C. 20006-5409

(202) 331-8585

FAX (202) 331-2032

THOMAS C. THOMPSON, JR.
MARK H. KOVEY
STEPHEN P. DICKE
PETER H. WINSLOW
SUSAN J. HOTINE
BIRUTA P. KELLY
GREGORY K. OYLER
LORI J. JONES
SAMUEL A. MITCHELL
LYNLEE C. BAKER

FRED C. SCRIBNER, JR. (1908-1994)
LEONARD W. HALL (1900-1979)

TAX ISSUES SUMMARY

September 30, 2008

HIGHLIGHTS:

2008-2009 Priority Guidance Plan Released

On September 10, 2008, The IRS and Treasury released the 2008-2009 Priority Guidance Plan. Of the 314 projects identified for guidance, there are nine listed specifically for “Insurance Companies and Products.” *See Company Issues.*

LMSB Announces Tier III Issues

As part of its general program to classify certain issues, by importance, for audit coordination, on September 12, 2008, the IRS announced the Tier III issues. Tier III issues generally identify high compliance risks within an industry but do not require mandatory examination by audit teams; one might expect coordinating work in developing the issue and determining types of guidance required. *See Company Issues.*

LEGISLATION

1. In General — Financial Crisis Occupies Congress in Its Last Days Before Recess; Tax Legislation Other Than AMT Patch Unlikely

As Congress approaches the recess for elections, all its attention is likely to be focused on legislation to help stabilize the U.S. economy — otherwise referred to as the “Wall Street bailout.” On Monday, September 29th, just when Senate and House leaders thought they had a bipartisan agreement that would provide funds for Treasury to buy mortgage-backed securities from troubled financial institutions to provide more liquidity for the financial markets, the House failed to pass the bill. Congress then recessed for Rosh Hashanah, saying they would not take any further votes until Thursday. As negotiators go back to the drawing board, one might expect that Wall Street’s adverse reaction to the House vote will cause constituents to contact their representatives. Some say that constituents will not

react until “Main Street” fully understands that it, too, will be affected by the credit crunch on Wall Street. It is unlikely that Congress will recess for the elections until there is some resolution of the “bailout” package or the perceived need for a bailout.

In the meantime, efforts to pass an “extenders” bill, as well as an AMT patch, look like they will be unsuccessful. After trying to vote on a House extenders bill several times, the Senate finally passed a compromise bill that extended expiring provisions through 2009, as well as providing another AMT patch, for 2008. The bill also incorporated some previously offered energy incentives and provisions for disaster relief. The cost of the Senate’s extenders package was only partially offset by provisions that would tax offshore deferred compensation as current income, freeze I.R.C. § 199 benefits for oil and natural gas production income at 6 percent, and require cost basis reporting by securities brokers; the cost of the one-year AMT patch was not offset at all. The House leadership refused to allow a vote on the Senate’s bill. Instead it passed separate bills for disaster relief, a one-year AMT patch the cost of which was not offset, and an extenders package that was fully offset. The fully-offset extenders package is a non-starter for the Senate; it is unclear whether the Senate will take up the separate AMT patch passed by the House.

With all of the above left up in the air, both Houses did pass a continuing resolution for stopgap funding of the government at 2008 levels, until March 6, 2009. The continuing resolution just awaits the President’s signature.

2. American Academy of Actuaries Brief Congressional Staff on the Demographic Problems of Social Security

In a briefing of Congressional staff early in September, representatives of the American Academy of Actuaries (the Academy) explained that Social Security funding is not an economic problem, but a demographic problem that requires a demographic solution. “As life expectancy increases, the percentage of workers’ lives spent in retirement continues to grow, while the number of working years remains relatively constant.” The Academy expressed the view that any solution to the funding problem should include increases in the retirement age. Academy representatives pointed out, for example, that speeding up the change of the current maximum benefit retirement age to 67 (from 65) could eliminate 10 percent of the Social Security long-range deficit; changing the retirement age to 67 and then increasing it by one month every two years until the maximum benefit retirement age is 70 could eliminate 35 percent of the deficit; and changing the retirement age to 67 and increasing it by two months every year until it is 70 could eliminate 50 percent of the deficit.

POLICYHOLDER ISSUES

1. I.R.C. § 72(t) — Make-Up Distribution Is Not an Alteration in Substantially Equal Periodic Payments

In PLR 200835033 (June 3, 2008), the IRS concluded that a 2007 “make-up” distribution composed of a taxpayer’s individual retirement agreement, after a failure to make a 2006 distribution,

will not result in an alteration to a series of substantially equal periodic payments under I.R.C. § 72(t)(4). Accordingly, the distributions will not be subject to the additional 10 percent tax imposed on early distributions.

2. I.R.C. §§ 468B and 6041 — No Information Reporting for Qualified Settlement Fund Distributions

In PLRs 200835016 (May 22, 2008) and 200835017 (May 22, 2008), the IRS ruled that payments made by an I.R.C. § 468B qualified settlement fund created to process, liquidate, and pay personal physical injury tort claims are excluded from gross income under I.R.C. § 104(a)(2) as damages received. Accordingly, the settlement funds are not required to issue information returns for payments made to claimants.

COMPANY ISSUES

1. I.R.C. § 162 — Coordinated Issue Paper Released on Deductions for Settlement Paid to DOJ

On September 5, 2008, the IRS's Large and Mid-Sized Business Division (LMSB) released a coordinated issue paper explaining when a payment made by a taxpayer to the Department of Justice in settlement of a False Claims Act (FCA) lawsuit would be deductible in its entirety under I.R.C. § 162(a) as an ordinary and necessary business expense and when a portion would be a nondeductible penalty amount under I.R.C. § 162(f). The paper concludes that part of an FCA civil fraud settlement may be a nondeductible penalty if the government's intent in assessing multiple damages was punitive and not compensatory; the part of the settlement payment that represents multiple damages, less certain relator fees, will be a nondeductible penalty. The paper also concludes that, under both I.R.C. §§ 162(a) and (f), the taxpayer has the burden of establishing deductibility of any payment or portion thereof. The coordinated issue paper cites TAM 200502041 (Oct. 26, 2004) as having a detailed discussion of the law and appropriate analysis relating to the issue.

2. I.R.C. § 336 — IRS Releases Proposed Regulations under I.R.C. § 336(e)

At the end of August, the IRS issued proposed regulations (REG-143544-04) under I.R.C. § 336(e) which, like I.R.C. § 338(h)(10), allows a corporation to elect to treat the sale, exchange, or distributions of stock it owns in a separate corporation as an asset exchange, thereby qualifying for nonrecognition for tax purposes. The election for I.R.C. § 336(e) nonrecognition can be made if the corporation sells, exchanges, or distributes at least 80 percent of the target corporation's voting power and stock value, as determined under Treas. Reg. § 1504(a)(2). A mixture of sales, exchanges, and distributions may be used to reach the 80 percent threshold. Unlike I.R.C. § 338(h)(10), the proposed regulations do not require the recipient of the stock to be a corporation, and the seller would not need the purchaser's cooperation to make the election.

The regulations would not apply to foreign corporations or to transactions between related entities. Similarly, S corporations also are excluded from making the I.R.C. § 336(e) election. The IRS

and Treasury solicited comments and public hearing requests regarding transactions beyond the scope of the proposed regulations for which elections should be allowed, and under what terms and conditions. Comments and requests for a public hearing must be submitted by November 24, 2008.

3. I.R.C. § 446 — IRS Unveils Transition Relief Using Procedures That Modify Requirements for Accounting Method Changes

IRS Announcement 2008-84, 2008-38 I.R.B. 748, modifies the effective date of Rev. Proc 2008-52, 2008-36 I.R.B. 587, which provides the procedures for taxpayers obtaining automatic consent for accounting method changes. Rev. Proc. 2008-52 states that all applications to modify a method of accounting subject to the automatic consent requirements that are filed by a taxpayer after August 17, 2008, for a year of change ending after December 30, 2007, must be filed using the provisions of Rev. Proc. 2008-52. The IRS recognized that the August 18, 2008 effective date of Rev. Proc. 2008-52 presented an administrative burden to some taxpayers. Thus, the Announcement provides that taxpayers can elect to apply the procedures of Rev. Proc. 2002-9 through September 15, 2008.

4. I.R.C. § 461 — Timing for Accrual of Insurance Agent Commission Expenses

In CCA 200836026 (May 9, 2008), the IRS National Office sent notice and advice to the field regarding the proper timing for an insurance company to treat its commission liability to agents as incurred, saying that the facts surrounding the company's agreements with its brokers should determine when the company's liability to pay broker commissions under any policy becomes fixed. For the case in point, the IRS National Office said that the facts needed to be developed further.

The insurance company uses independent brokers to sell its products and pays the brokers with commissions based on premiums. The insurance company also issues policies paid through deductions to employee payroll accounts; the premiums are paid periodically throughout coverage. The insurance company accounts for its commission liability on the accrual method and had asked whether it may treat its commission liability as incurred on payment to the agents and before the receipt of the premiums to which the commission liability relates. The CCA noted that, under I.R.C. § 461(h) and an accrual method of accounting, a liability is incurred and generally taken into account for tax purposes in the tax year in which all events have occurred to establish the fact of the liability, the amount can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. The CCA concluded that further factual development is necessary to determine the appropriate time for treating the insurance company's commission liability as incurred. (*Query*: Why would "payment" of the commissions not be economic performance? Could the payments have been advanced commissions structured as a loan?)

5. I.R.C. §§ 6011 and 6707A — IRS Reveals Rules on Penalty Rescission For Failure to Disclose Reportable Deals

In early September, the IRS released proposed and temporary regulations (REG-160868-04, T.D. 9425) regarding the imposition of penalties under I.R.C. § 6707A for failure to disclose reportable transactions under I.R.C. § 6011. The regulations offer guidance on when the Commissioner would use its power to rescind I.R.C. § 6707A penalties.

The regulations provide generally that a taxpayer can incur a separate penalty under I.R.C. § 6707A for each reportable transaction the taxpayer was required to disclose, but failed to do so within the specified time and in the specified manner. The regulations generally adopt the factors set forth in Rev. Proc. 2007-21, 2007-1 C.B. 613, that weigh in favor of or against granting rescission of the I.R.C. § 6707A penalty. The regulations contain a series of seven new examples that illustrate how rescission would work in practice. The examples are said to be the most significant new change. The rules also add a new item to the list of factors that weigh in favor of granting rescission, noting that the IRS will look at whether the penalty assessed is disproportionately larger than the tax benefit received. The IRS said factors it will use in deciding whether or not to rescind a penalty “reflect circumstances that suggest that sustaining assessment of the penalty is against equity and good conscience.” Nevertheless, the factors are nonexclusive and no single factor will be determinative.

6. 2008-2009 Priority Guidance Plan Released

On September 10, 2008, The IRS and Treasury released the 2008-2009 Priority Guidance Plan. Areas of guidance included in the Plan that are of particular interest to the insurance industry are:

- Final regulations on the exchange of property for an annuity contract (proposed regulations were published on October 18, 2006).
- Guidance on the tax treatment of partial exchange of partial annuitization of an annuity contract.
- Guidance on employer-owned life insurance under I.R.C. § 101(j).
- Guidance on the classification of certain cell captive insurance arrangements (previous guidance published in Notice 2008-19).
- Revenue ruling providing guidance on reinsurance arrangements entered into with a single ceding company.
- Guidance on tax issues arising under I.R.C. § 807 as a result of the adoption by the NAIC of an actuarial guideline setting forth the Commissioners’ Annuity Reserve Valuation Method for variable contracts (VA CARVM).
- Revenue ruling regarding the tax-free exchange of life insurance contracts subject to I.R.C. § 264(f).
- Guidance on the determination of the company’s share and the policyholders’ share of net investment income of a life insurance company under I.R.C. § 812.
- Final regulations concerning information reporting on employer-owned life insurance contracts under I.R.C. § 6039I.

In total, the Plan identifies 314 projects expected to be completed between July 1, 2008 and June 30, 2009.

7. LMSB Announces Tier III Issues

As part of its general program to classify certain issues, by importance, for audit coordination, on September 12, 2008, the IRS announced the Tier III issues (Tier I issues being those with strategic significance because of the number of taxpayers and dollars involved, and viewed, like listed transactions, as requiring nationwide coordination; and Tier II issues being those that are important, but

do not require nationwide coordination). Tier III issues generally identify high compliance risks within an industry but do not require mandatory examination by audit teams; one might expect coordinating work in developing the issue and determining types of guidance required.

The Tier III issues list includes two issues for each of LMSB's five industry issues focus groups:

- *Communication, Technology and Media*: launch fees paid to cable operations, and amortization of intangibles;
- *Financial Services*: real estate mortgage investment conduits, and premium deficiency reserves;
- *Heavy Manufacturing and Transportation*: uniform capitalization for automobile dealerships, and service loyalty programs;
- *Natural Resources and Construction*: delay rental payments, and I.R.C. § 198 environmental remediation costs;
- *Retailers, Food, Pharmaceuticals and Healthcare*: cost segregation studies, and vendor allowances.

8. Audit Technique Guide on Foreign Insurance Excise Taxes Released

The IRS recently posted on its website a foreign insurance excise tax audit technique guide that was developed in April of 2008. The guide explains that I.R.C. § 4371 requires three elements for the foreign insurance excise tax to apply — an insurance policy, insurance of a U.S. risk, and a policy issued by a foreign insurer or reinsurer. The guide has twelve chapters covering a wide range of topics, including location of the insured party, identification of the parties to an insurance contract, table premiums, exemptions, captive insurance companies, cascading insurance, consolidated returns, pooling of risks, insurance company reinsurance, claims, and other sources of information.

IRS Circular 230 Disclosure:

This newsletter is provided solely for informational purposes and is not intended to furnish legal advice with respect to the reader's particular factual circumstances. In accordance with § 10.35 of IRS Circular 230 requirements, you are advised that any discussion of tax issues in this newsletter is not intended or written to be used, and cannot be used, to avoid penalties imposed under the Internal Revenue Code or to promote, market or recommend to another party any transaction or matter addressed herein. The persuasiveness of this newsletter's discussion with regard to the tax issues in question and a taxpayer's good faith reliance on the newsletter will be determined under applicable provisions of the law and regulations (§ 10.35(f)).

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