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TAX ISSUES SUMMARY

October 29, 2008

***HIGHLIGHTS*:**

I.R.C. § 817(h) — IRS Assures that Money Market Funds Will Not Violate Diversification Rules

In Notice 2008-92, 2008-43 I.R.B. ___, the IRS announced that money market funds held by insurance companies for variable contracts generally will not violate diversification rules if they participate in a government rescue program to insure those funds at $1 per share. Additionally, the IRS will not assert that the contract holder of a variable contract based on a segregated asset account invested in such funds is an owner of the underlying fund shares. *See* Policyholder Issues.

I.R.C. § 817 — IRS National Office Advises Field re Withdrawn Ruling on Investor Control

The IRS released CCA 200840043 (June 10, 2008), notifying the field of a life insurance company's withdrawn ruling request concerning a variable contract and who would own the underlying assets. The CCA concluded that "[w]here a segregated asset account directly invests in assets available to the general public, the policyholder and not the . . . [company] is the owner of the assets in the segregated asset account." *See* Policyholder Issues.

LEGISLATION

1. In General — Financial Crisis Continues to Occupy Center Stage for Congress; Made Passage of Extenders and the AMT Patch Possible

After the House failed to pass the "bailout bill" that was worked out with the Administration in the last days of September, the Senate took the lead in putting together a larger package that included

non-bailout provisions to attract the requisite number of votes both in the Senate and in the House. H.R. 1424 contained the Emergency Economic Stabilization Act of 2008 (otherwise referred to as the "bailout bill"), the Energy Improvement and Extension Act of 2008, and the Tax Extenders and Alternative Minimum Tax Relief Act of 2008. The Emergency Economic Stabilization Act authorizes Treasury to buy "troubled" illiquid assets from or to invest directly in struggling banks, to the tune of $700 billion. It also contained several tax provisions to relieve balance sheet pressure of struggling banks (i.e., gains or losses from the sale of Fannie Mae and Freddie Mac preferred stock will be treated as ordinary), to prevent some top executives from profiting from taxpayer funds (i.e., companies that participate in the rescue plan face tighter limits on tax deductions for executive compensation), and to help homeowners to refinance mortgages to avoid foreclosure (i.e., the exclusion of mortgage debt relief from cancellation of indebtedness income is extended until 2012). Although insurance companies might have limited opportunity to participate in the benefits of the bailout bill, whether or not they participate, they might well be required to participate under the recoupment provision that requires, in five years, that the President submit to Congress a proposal to recoup from the "financial industry" any projected losses to the taxpayer for the bailout bill.

Under the Energy Improvement and Extension Act, renewable energy credits were extended and new alternative energy credits were adopted, as well as a set of coal and carbon mitigation incentives being adopted. The cost of the energy provisions was offset by a requirement that brokers report cost basis information for stock and other securities transactions to the IRS, a one-year extension of the 0.2 percent Federal Unemployment Tax Act income surtax, and various provisions that increase taxes on the oil and gas industry. Though it looked in doubt, a two-year extension of expiring provisions through 2009 and a one-year AMT patch for 2008 (as previously passed by the Senate) was also included as part of H.R. 1424, as the Tax Extenders and Alternative Minimum Relief Act. The extenders for individuals include the deduction for state and local taxes, the qualified tuition and expenses deduction, a provision letting RICs designate some dividends as interest-related dividends, and the designation of RICs as qualified investment entities under I.R.C. § 897. For business, there was a extension of the active financing income exemption under subpart F, extension of the research credit and the new markets credit. The only revenue raising provision for the extenders and AMT patch is one that treats deferred compensation paid to individuals by "tax indifferent parties" (i.e., companies operating in tax haven countries) as current income beginning in 2009.

2. Second Economic Stimulus Package — During a Lame Duck Session?

As the elections near and the economy still seems to be stalled, Democrats have been floating the idea of passing a second economic stimulus package. The idea received a boost from Ben Bernanke, Chairman of the Federal Reserve Board, who told the House Budget Committee that the economy would likely be weak for several quarters and that consideration of another economic stimulus package seems appropriate. Democrats are calling for elimination of taxes on unemployment benefits, a loosening of required minimum distribution rules for individual retirement accounts, and more funding for infrastructure improvements and aid to states; Republicans are calling for making the 2001 and 2003 tax cuts permanent so that existing businesses will have certainty to undertake new projects and invest in job

creation, as well as lowering taxes on capital gains and corporate income. Previously opposed to a second economic stimulus package, the Administration now has removed its general objections, but has not taken any position on what a second package should contain. If the economy continues its decline in the next few weeks, Congress could use a lame duck session in mid-November to pass a second economic stimulus package. The package is likely to include both spending and tax incentives. The question is whether there will be any attempt to offset the cost of the package.

3. New Law Prevents College Students from Losing Insurance Due to Medical Leave

On October 9th, President Bush signed H.R. 2851 into law. Known as Michelle's Law, the measure requires group health plans to continue coverage for dependent college students on medical leave for one year after the first day of the medically necessary leave of absence, or until the date on which such coverage otherwise would terminate under the terms of the plan. I.R.C. § 4980D(a) imposes an excise tax of $100 per day, per individual on failure to meet the group health requirements of Chapter 100.

POLICYHOLDER ISSUES

1. I.R.C. § 72 — IRS Rules that Failure to Distribute IRA Payment Is Not Modification

In PLR 200840054 (July 8, 2008), the IRS ruled that a taxpayer, who began receiving monthly distributions from an IRA intended to comply with the substantially equal periodic payment (SEPP) rules of I.R.C. § 72(t)(2)(A)(iv) would not be considered to have experienced a modification of the SEPPs, causing them to be subject to the 10-percent additional tax merely because the taxpayer missed receiving a couple of months' payments. The facts indicated that the missed payments were caused by the taxpayer's change in custodians, and were corrected with additional payments by the new custodian soon after the situation was discovered. The IRS concluded that the failure to distribute the entire required annual payment from the IRA one year and the subsequent corrective distribution made in the following calendar year (such that the amount distributed in each of the two years varied from the required annual payment) will not be considered a modification of the SEPPs and, therefore, the distributions from the IRA will not be subject to the 10-percent additional tax imposed on premature distributions under I.R.C. § 72(t)(1).

2. I.R.C. § 512 — Court Finds that VEBA Did Not Avoid Exempt Function Income Limitation by Allocating Investment Income

On October 21st, the U.S. Court of Federal Claims found that a volunteer employees' beneficiary association (VEBA) may not avoid the limitation on exempt function income in I.R.C. § 512(a)(3)(E)(i) merely by allocating investment income toward the payment of welfare benefits during the course of the tax year. (*CNG Transmission Management VEBA v. United States*, Fed. Cl. No. 06-541T.) The taxpayer

CNG in this case is a VEBA organized under I.R.C. § 501(c)(9). Under I.R.C. § 501(c)(9), an employer-funded VEBA is an entity that provides for the payment of life, sick, accident, or other benefits to the members of the association or their dependents or designated beneficiaries. A VEBA also maintains certain set-aside funds to provide for those "welfare" benefits to its members. While the VEBA itself is tax-exempt, it must pay tax on the UBTI. At issue in the case was whether CNG is due a refund for taxes payed on unrelated business taxable income (UBTI). The court noted that I.R.C. § 512(a)(3)(E)(i) is ambiguous, but that Treas. Reg. § 1.512(a)-5T provides clarity on the issue. The court ruled that the taxes paid on the UBTI were proper, and that CNG did not present any evidence that it is entitled to the tax refund sought.

3. I.R.C. § 817(h) — IRS Assures that Money Market Funds Will Not Violate Diversification Rules

In Notice 2008-92, 2008-43 I.R.B. ___, the IRS announced that money market funds held by insurance companies for variable contracts generally will not violate diversification rules if they participate in a government rescue program to insure those funds at $1 per share. Specifically, the Notice states that participation in the Exchange Stabilization Fund will not violate the diversification requirements found in I.R.C. § 817(h) in the case of a segregated asset account that invests in an insurance-dedicated money market fund. Additionally, the IRS will not assert that the contract holder of a variable contract based on a segregated asset account invested in such funds is an owner of the underlying fund shares.

4. I.R.C. § 817 — IRS National Office Advises Field re Withdrawn Ruling on Investor Control

The IRS released CCA 200840043 (June 10, 2008), notifying the field of a life insurance company's withdrawn ruling request concerning a variable contract and who would own the underlying assets. The CCA concluded that "[w]here a segregated asset account directly invests in assets available to the general public, the policyholder and not the . . . [company] is the owner of the assets in the segregated asset account." The CCA cites various investor control rulings, but contains no real analysis in support of this conclusion. Thus, the CCA's conclusion seems to be overly broad and inconsistent with what might be viewed as the paradigm for a segregated asset account, that is, one that does not use a regulated investment company ("RIC") structure for the underlying investments, but is a group of investment assets identified by the company.

Under the facts described in the CCA, the company proposed to create a segregated asset account for each policy. Each segregated asset account would be managed by an investment advisor retained by the company after being nominated by the policyholder. The nominated investment advisor could not be related or subordinate to the policyholder, and the company would generally accept such nomination. The investment advisor had sole and unfettered discretion to make all investment decisions for the segregated asset account, but the policyholder would submit a questionnaire providing answers regarding investment horizons, investment goals, risk tolerance, risk profile, comfort with investments in different

geographical regions (i.e., Latin America, Eastern Europe, Far East, Western Europe, Australia), and comfort level with different types of investment vehicles (e.g., real estate, ADR's, partnerships, etc.). The contract provided that there would be no agreements, understandings or communications between the policyholder and the company or the investment advisor regarding the investments in the segregated asset account, other than the guidance provided by the questionnaire.

5. I.R.C. § 2105(b)(1) — Gross Estate of Nonresident Non-Citizen of the United States Does Not Include Annuity Proceeds Held on Deposit by U.S. Insurance Companies

In PLR 200842013 (June 13, 2008), the IRS concluded that annuity proceeds and accrued interest left on deposit with the issuing life insurance companies by the annuity contract beneficiary, who was a nonresident and not a citizen of the United States, was not includable in the gross estate of the decedent beneficiary. The United States imposes a tax on the gross estate of nonresident non-U.S. citizen, which consists of any property situated in the United States at the time of such person's death. However, deposits are not considered property situated in the United States if the interest thereon would not have been subject to tax if received by the decedent directly. Interest paid to a nonresident non-U.S. citizen on amounts held by an insurance company under an agreement to pay interest would not be subject to tax under I.R.C. § 871(i)(3). The IRS concluded that the annuity proceeds were being held by the insurance companies as deposits and, therefore, were not property situated in the United States. Thus, the annuity proceeds and accrued interest were excluded from the decedent beneficiary's gross estate.

Note that this private letter ruling is limited to the estate tax issue and does not address whether there may be any income tax consequences when the annuity proceeds are distributed.

COMPANY ISSUES

1. I.R.C. § 162 — Settlement Payments to Resolve Lawsuits Are Not Deductible

In *WellPoint Inc. V, Commissioner*, T.C., No. 13585-05, T.C. Memo. 2008-236 (Oct. 27, 2008), the Tax Court concluded that Well Point is not entitled under I.R.C. § 162(a) to deduct three settlement payments that were made to resolve lawsuits brought by three state attorneys general, nor the legal and professional fees incurred to defend the lawsuits. The court found that both the payments and the expenses were not deductible because they were capital expenditures based on the origin of the claim doctrine. Because the state attorneys general brought suit to recover equitable title to assets they believed were impressed with charitable trusts, the origin of the claim in all three suits were disputes over title to assets. The fact that WellPoint made the settlement payments to avoid interruption of business or loss of good will was found to be irrelevant; "[a] taxpayer's motive for settling is not controlling in determining whether the settlement payment is deductible."

2. I.R.C. § 807 — IRS Website Has Guidance on Reporting Rules for Minimum Reserves

On its website, the IRS offers guidance to life insurance companies doing business in several states with different minimum reserve requirements. The posting follows Rev. Rul. 2008-37, 2008-28 I.R.B. 77, which said that the amount of the company's statutory reserves should be the highest aggregate reserve amount set forth on an annual statement, pursuant to the minimum reserve requirements of any state in which the company does business. The posting offers information to life insurance companies on how to file returns in order to be in compliance with the revenue ruling. In general, companies must ensure that the IRS has a copy of any annual statement which the company uses as the basis for taxable income. The web posting is available at http://www.irs.gov/formspubs/article/0,,id=109875,00.html.

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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
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