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TAX ISSUES SUMMARY

December 30, 2008

HIGHLIGHTS:

I.R.C. § 72 — Termination of Policy to Recover Outstanding Loan Triggers Income recognition Provisions

In *Reinert v. Commissioner*, Dkt. No. 24409-07S (Dec. 23, 2008), the United States Tax Court determined that, for tax purposes, a triggering event occurred when an individual's life insurance policy was terminated because the loan amount owed exceeded the allowed cash value limit. The court found taxpayer liable for the taxes due on the ordinary income received as a result of the policy being terminated and the loan amount being repaid by the policy's cash value. *See* Policyholder Issues.

I.R.C. § 165 — IRS Suggests Several Cases as Guidance on Establishing Worthlessness

In ECC 200851050 (Oct. 27, 2008), the IRS suggests several cases as providing guidance on when abandonment is an identifiable event establishing worthlessness. *See* Company Issues.

LEGISLATION

1. In General

The month of December had Congress again focusing on the consequences of the financial crisis and the worsening economy. However, the only legislative accomplishment was passage of the Worker, Retiree, and Employer Recovery Act of 2008 (H.R. 7327), which was signed by the President on December 23rd. The Act suspends the minimum required distributions for 2009 for taxpayers who are seventy and a half; allows single-employer plans three years to phase in pension funding target percentages under the Pension Protection Act of 2006 ("PPA"); permits single-employer plans to temporarily adjust PPA's plan contribution, distribution, and projected earnings provisions; allows multi-employer plans to freeze the funding status of their plans to allow time for economic recovery; lets multi-employer plans elect a three-year extension of current amortization rules to help offset asset losses in

2008; temporarily suspends limits on benefit accruals for participants in underfunded pension plans; and implements technical corrections to provisions of the PPA affecting cash balance pension plans, asset smoothing, market rates of return for governmental plans, and other issues.

Congress gave further consideration to a bill that would help the U.S. automobile industry, and also called for some restructuring as a condition for the financial aid. In the end, because of Republican-led opposition, the bill was not passed. Left with the possibility of at least one of the automakers not surviving the end of the year, the Administration stepped in and provided a bridge loan to carry the companies through the first part of 2009. Congress also considered what might be contained in a second stimulus package, but details were left to be worked out with the new Administration. Given that the economic conditions have not turned around, the new Congress and new Administration are expected to hit the ground running.

2. Senate Finance Committee Floats Draft Bill on Foreign Reinsurance

On December 10th, the Senate Finance Committee released a discussion draft of legislation aimed at preventing foreign-owned insurers from receiving a tax advantage over domestic insurers by reinsuring U.S. risks with related foreign affiliates. Generally, the draft would modify I.R.C. § 832(b) to deny the direct writer a deduction for any premium paid for reinsurance that is in excess of an “industry average” premium for reinsurance, for tax years beginning after 2008. The Committee called for comments, to be submitted by February 28, 2009, on the possible effect on insurance pricing and capacity; issues relating to existing treaties and sovereignty rights of other jurisdictions; the potential impact on the reinsurance market; U.S. competitiveness; possible impact on crop insurance; and the effective date of the proposal. The Finance Committee draft is similar to a proposal introduced by Congressman Richard Neal (D-Mass), chairman of the Ways and Means Select Revenue Measures Subcommittee.

POLICYHOLDER ISSUES

1. I.R.C. § 72 — Termination of Policy to Recover Outstanding Loan Triggers Income recognition Provisions

In *Reinert v. Commissioner*, Dkt. No. 24409-07S (Dec. 23, 2008), the United States Tax Court determined that, for tax purposes, a triggering event occurred when an individual’s life insurance policy was terminated because the loan amount owed exceeded the allowed cash value limit. The notice sent to the policyholder about the termination advised that the termination would trigger a taxable event, and would result in ordinary income. The taxpayer argued that, because he did not voluntarily or physically surrender the policy, it should not be considered a taxable event. Additionally, the taxpayer contended that the insurance company used the termination as “leverage to force policy holders to pay interest on their outstanding loans borrowed against the case surrender value of their policies.” The Tax Court declined to accept the taxpayer’s argument, instead finding that the notice given to him by the insurance company was sufficient to allow him to prevent the termination of the policy had he so chosen. Because he opted to let the policy terminate rather than pay the interest on the loans outstanding as outlined in the

policy, it did not matter whether the policy was “terminated” by the insurance company or “surrendered” by the policyholder. The court found him liable for the taxes due on the ordinary income he received as a result of the policy being terminated and the loan amount being repaid by the policy’s cash value.

2. I.R.C. § 264(f) — New York State Bar Association Tax Section Asks for Clarification on Investor-Owned Life Insurance Issues

In a letter dated December 5th, the New York State Bar Association (NYSBA) Tax Section asked the IRS and Treasury to take action and clarify three issues related to investor-owned life insurance. The three areas for which the NYSBA requested clarification are the character of gains or losses on sales, the adjusted basis for purposes of gain or loss, and the operation of I.R.C. § 264(f) with respect to such contracts. Additionally, the NYSBA requested that the IRS and Treasury clarify that I.R.C. § 1234A does not apply to amounts received under a life insurance policy from the insurance company when the policy either matures upon the insured’s death or is cancelled.

3. I.R.C. § 403(b) — Temporary Relief from Written Plan Requirement for Certain Retirement Plans

In Notice 2009-3, 2009-2 I.R.B. ____, the IRS has issued guidance providing relief during 2009 for sponsors of I.R.C. § 403(b) plans regarding the requirement to have a written I.R.C. § 403(b) plan in place by January 1, 2009. The Notice states that the IRS will not treat an I.R.C. § 403(b) plan as failing to satisfy the requirements of that section during the 2009 calendar year if the sponsor has adopted a written plan by December 31, 2009, that satisfies all the requirements of the regulations, is effective as of January 1, 2009, and has been administered consistent with the regulations throughout 2009. The Notice also describes other guidance the IRS and Treasury anticipate establishing for I.R.C. § 403(b) plans in the future.

4. I.R.C. § 403 — IRS Rules that LLC Employees May Participate in Qualified Annuity Plan of Parent

In PLR 200851044 (Sep. 24, 2008), the IRS has ruled that the employees of a single-member limited liability company (LLC) owned by a nonprofit health system may be treated as employees of the tax-exempt health system for purposes of participation in its I.R.C. § 403(b) annuity plan. In the facts of the ruling, Employer M is a multi-facility health system. Employer M purchased Company O, which is a single-member LLC. The IRS noted that because Company O has not elected to be classified as an association under the rules of Treas. Reg. § 301.7701-3(a), it is disregarded for federal tax purposes. This means that employees of Company O will be treated as employees of Employer M for purposes of Treas. Reg. § 301.7701-3(a), and will be allowed to participate in the company’s I.R.C. § 403(b) plan.

5. I.R.C. § 501(m) — Annuities Sold Through a Charitable Gift Annuity Program Are Not Commercial-Type Insurance

In PLR 200852037 (Sep. 30, 2008), the IRS ruled that the sale of annuities by a public charity through a charitable gift annuity program does not constitute the provision of commercial-type insurance

under I.R.C. § 501(m). Rather the contracts qualify for the exception under I.R.C. § 501(m)(3)(E) and meet the definition of a charitable gift annuity under I.R.C. § 501(m)(5). The IRS also ruled that income derived from the program by the charity will not constitute unrelated business taxable income.

6. I.R.C. § 2511 — IRS Rules Policy Proceeds Not Included in Gross Estate

In PLR 200848002 (Aug. 19, 2008), the IRS ruled on issues concerning the federal gift, estate, and generation-skipping transfer tax consequences of a split-dollar life insurance agreement between two trusts involving two life insurance policies. In the facts of the ruling, a husband and wife established an irrevocable trust for the benefit of their grandchildren. The trustees of the trust are the couple's three children. Under the terms of the trust, net income is to be paid in equal shares to the grandchildren annually. The trust purchased two second-to-die life insurance policies on the lives of the grantors of the trust. The trust was the owner and beneficiary of the policies. The grantors and the trustees then entered into a collateral assignment split-dollar life insurance agreement. The issues in the ruling are: (1) whether the payment by the grantors of the premiums pursuant to the agreement will result in a gift to the trust under I.R.C. §§ 2501 and 2511; and (2) whether the insurance proceeds payable to the trust will be includable under I.R.C. § 2042 in the gross estate of the grantors. The IRS concluded that the grantors payments would be treated as gifts if and when some or all of the cash surrender value is used, either directly or indirectly, to fund the trust's obligation to pay premiums. Further, the IRS concluded that insurance proceeds payable to the trust would not be includable in the gross estates of the grantors. *See* PLR 200851013 (Sept. 9, 2008) for the same conclusions in another situation.

7. Ninth Circuit Rules that Fiscal Event Insurance Does Not Cover Company's Tax Settlements

In *Upper Deck Co. LLC v. American International Specialty Lines Ins. Co.*, (Dkt. No. 07-56070, Dec. 12), the U.S. Court of Appeals for the Ninth Circuit upheld an arbitration panel's conclusion that the Plaintiff's insurance did not cover an \$80 million tax settlement the company entered into with the IRS. The Ninth Circuit decision also affirmed a ruling last year in the U.S. District Court for the Southern District of California, which also upheld the panel's conclusion. In the facts of the case, Upper Deck, a sports trading card manufacturer, took out an insurance policy with American International Specialty Lines Insurance (AISLIC). AISLIC drafted a fiscal event insurance policy designed to cover tax liabilities associated with the KPMG tax shelter known as "Subchapter S Charitable Contribution Strategy". Upper Deck issued 8.28 million shares of nonvoting common stock to a trust which then donated those shares to charity. The shares had a value of approximately \$1.4 million in March 2001. The contribution strategy anticipated that the company would allocate 90 percent of its income to the charity, which would not pay taxes on the income. The trust would also not pay taxes on income allocated to the charity. The charity and the trust entered into a shareholder's agreement that prescribed the conditions under which the charity could sell or transfer the shares. At the end of 2002, Upper Deck repurchased the shares for \$2 million, though their fair market value was \$11.3 million. Upper Deck entered into a settlement with the IRS for back taxes and interest related to its involvement in the shelter. The court accepted AISLIC's argument that the insurance policy did not cover Upper Deck's loss because the shareholder's agreement required that the shares be repurchased at market price as determined by an independent appraisal. There was no evidence that the shares' value at the time of repurchase was the \$2 million that Upper Deck paid.

COMPANY ISSUES

1. **I.R.C. § 165 — IRS Suggests Several Cases as Guidance on Establishing Worthlessness**

In ECC 200851050 (Oct. 27, 2008), the IRS suggests several cases as providing guidance on when abandonment is an identifiable event establishing worthlessness. The emailed advice cites the cases of *Proesel v. Commissioner*, 77 T.C. 992 (1981), *Echols v. United States*, 950 F.2d 209 (5th Cir. 1991), *McCarthy v. United States*, 129 F.2d 84, 86 (7th Cir. 1942), *Burke v. Commissioner*, 32 T.C. 775, 780-81 (1959), *Laport v. Commissioner*, 671 F.2d 1028, 1032 (7th Cir. 1982), *Helvering v. Gordon*, 134 F.2d 685, 689 (4th Cir. 1943), *Hummel v. United States*, 227 F. Supp. 30, 3233 (D. Cal. 1963), *Haspel v. Commissioner*, 62 T.C. 59, 71 (T.C., 1974), *Louisville & Nashville RR. Co. v. Commissioner*, 66 T.C. 962, 1004-10 (T.C. 1976), and *Jupiter Corp. v. United States*, 2 Cl. Ct. 58, 71 (Ct. Cl. 1983) for guidance on this issue.

2. **I.R.C. § 409A — IRS Issues Guidance on Reporting and Withholding, Solicits Comments on Proposed Regulations**

The IRS issued proposed regulations (REG-148326-05) that provide guidance on the calculation of amounts includable in income when the requirements of I.R.C. § 409A are not met, and include how to calculate additional taxes that apply to such income. The proposed rules would be effective for taxable years on or after the date of publication of the final regulations. The IRS has requested comments on the proposed regulations that are due by March 9, 2009; a public hearing scheduled for April 2, 2009.

The IRS also issued Notice 2008-113, 2008-51 I.R.B. ____, which updates the correction program for I.R.C. § 409A, allowing taxpayers to correct certain operational failures or limit the amount of additional taxes due for failure to comply with that code section. It expands and clarifies the existing correction program as laid out by Notice 2007-100, 2007-52 I.R.B. 1243.

Finally, the IRS issued Notice 2008-115, 2008-52 I.R.B. 1367, which provides guidance on the calculation and reporting of amounts deferred under I.R.C. § 409A. The Notice states that reporting of amounts deferred under this code section on Forms W-2 or 1099-MISC is not required for 2008.

3. **I.R.C. § 831 — IRS Addressed Risk Shifting and Risk Distribution for Insured Group**

In CCA 200849013 (July 24, 2008), the IRS addressed risk shifting and risk distribution issues within an insured group of related insureds. The IRS National Office concluded that the aggregation of the group's premiums was incorrect where such aggregation ignored the separate entity status of lower tier subsidiaries that were not shams or unreal. The IRS declined to provide advice on the relevance of homogeneity of risk for purposes of determining treatment as insurance, pending the publication of guidance per Notice 2005-49, 2005-2 C.B. 14.

The CCA focused on the facts of a company-taxpayer that was a member of a mutual insurance company that wholly-owned a segregated cell company that formed a segregated cell to provide

insurance coverage to corporations, subsidiaries, firms, or individuals acquired, organized, or controlled by each member of the mutual insurance company. Each cell was set up as a captive and identified with a specific member. At issue was whether risk was adequately shifted and distributed if each insured is considered a brother-sister corporation of the cell. The IRS also was asked to determine whether risk was adequately shifted and distributed if each insured is treated as an owner of the cell for purposes of determining if an insured or policyholder has an equity interest in the cell.

4. I.R.C. § 832(f) — IRS Rules on Deduction for Reciprocal Interinsurer

In PLR 200852018 (Sep. 15, 2008), the IRS determined that a domestic captive risk retention group operated as an interinsurer and, as such, is entitled to a deduction for the increase for the taxable year in savings credited to Subscriber Savings Accounts pursuant to I.R.C. § 832(f) and corresponding regulations.

5. I.R.C. § 1221 — Failure to Identify Hedging Transaction Precludes Capital Gain Treatment

In ECC 200851082 (Sep. 2, 2008), the IRS has considered whether a taxpayer had reasonable grounds for failing to identify a hedging transaction (i.e., made an “inadvertent error” within the meaning of Treas. Reg. § 1.1221-2(g)(2)(ii)) for capital gains purposes; and whether, if there was an inadvertent error, the taxpayer would be immune from the anti-abuse rule of having the gain from the transaction was treated as ordinary under the Treas. Reg. § 1.1221-2(g)(2)(iii) anti-abuse rule. The email states neither the inadvertent error rule nor the anti-abuse rule the inadvertent error rule overrides or is an exception the IRS’ authority to challenge whether a taxpayer has reasonable grounds for failing to identify a transaction as a hedging transaction. The two provisions operate independently and have different purposes, convey differing rights to differing parties and have differing standards for their application. It goes on to deconstruct the taxpayer’s arguments as assumptive and improperly relying on a TAM which is not on point. The email also notes that the taxpayer’s argument that its error was “inadvertent” does not establish “reasonable grounds” as defined in Treas. Reg. § 1.1221-2(g)(2)(ii); simply stating that the error was inadvertent is not sufficient evidence to prove it was actually inadvertent.

6. I.R.C. § 1234A — Straddle Termination Provision Applies to Derivative Interests

In e-mailed advice (ECC 200851052, (Oct. 27, 2008)), the IRS noted that the rights-with-respect-to-capital-assets language in I.R.C. § 1234A refers to derivative interests. More specifically, the email says that “Section 1234A applies to ‘rights with respect to’ capital assets – that is, derivative interests.”

7. I.R.C. §§ 6011, 6111 and 6112 — IRS Names a New “Transaction of Interest”

In Notice 2009-7, the IRS designates as a “transaction of interest” an arrangement in which a taxpayer prevents inclusion of subpart F income by interposing a U.S. domestic partnership in a controlled foreign corporation (“CFC”) structure. The typical transaction identified involves a U.S. taxpayer owning two CFCs that are partners in a U.S. domestic partnership that wholly-owns a third CFC that has subpart F income. The U.S. taxpayer takes the position that the subpart F income of the third CFC is currently included in the income of the U.S. partnership, which is not subject to U.S. tax, and is

not included in the income of the U.S. taxpayer. The Notice and designation as a transaction of interest is effective December 29, 2008, for all transactions that are the same or substantially similar to those described that were entered into on or after November 2, 2006.

8. I.R.C. § 6015 — Tax Court Finds that ‘Taxes’ Includes Interest

In *Mary Ann Kollar v. Commissioner*, 131 T.C. No. 12 (Nov. 25, 2008), the Tax Court interpreted the word “taxes” to include accrued interest. In the facts of the case, the taxpayer, Mary Ann Kollar, filed a joint tax return for tax year 1996 claiming zero tax liability. Two years later, she filed an amended return and paid taxes for that year. The IRS deemed the taxes were untimely paid, and assessed accrued interest on them. Kollar then requested equitable relief from the unpaid interest, which the IRS denied. Kollar then filed suit in the Tax Court against the IRS. The IRS argued that under a prior-version of I.R.C. § 6015, the Tax Court did not have jurisdiction over nondeficiency stand-alone petitions for equitable relief. Congress amended I.R.C. § 6015 to give the court jurisdiction over such petitions “with respect to liability for taxes arising or remaining unpaid on or after [December 20, 2006].” The IRS argued that this meant that petitions for relief relating to tax liabilities for years prior to this date were excluded from the Tax Court’s jurisdiction. The Tax Court disagreed, finding that Congressional intent when defining “taxes” included interest and penalties. The Tax Court held that they did have jurisdiction over Kollar’s request.

9. I.R.C. § 6039I — Final Regulations on Information Reporting on Employer-Owned Life Insurance Contracts

The IRS issued final regulations (T.D. 9431) concerning information reporting on employer-owned life insurance contracts under I.R.C. § 6039I. The regulations apply to taxpayers that are engaged in a trade or business and that are directly or indirectly a beneficiary of a life insurance contract covering the life of an insured who is an employee of the trade or business on the date the contract is issued. Only one comment was received on the regulations as proposed (REG-115910-07). The comment dealt mainly with notice and consent requirements rather than the reporting requirements of I.R.C. § 6039I. Accordingly, the IRS adopted the proposed regulations with no substantive changes.

10. I.R.C. §§ 6694 and 6695A — IRS Issues Final Regulations on Preparer Penalties

On December 15, the IRS issued several guidance items related to return preparer penalties, including final regulations (T.D. 9436) under I.R.C. §§ 6694 and 6695A. The final regulations relating to I.R.C. § 6694 adopted most of the changes in the proposed regulations (REG-129243-07), with only minor modifications. The preamble to the regulation noted that more than 30 written comments were considered and the final regulations were influenced by issues raised by the commentators.

The government kept the new rule in the proposed regulations of “one preparer per position within a firm”, rather than the previous “one preparer per firm” rule. The preamble states that this furthers compliance and results in “more equitable administration.” In instances where there is no signing preparer with primary responsibility, a nonsigning preparer with overall supervisory responsibility will be considered to have primary responsibility for the position absent credible information to the contrary. A provision was added to address a situation in which both a signing and a

nonsigning preparer could be found to have primary responsibility. In that situation, the IRS may assert a penalty against either individual, but not both. The final rules, like the proposed regulations, allow a return preparer to rely in good faith on information provided by another adviser or preparer without verification unless circumstances suggest a duty of further inquiry.

The regulations state that the “reasonable to believe” more-likely-than-not standard was intended to be the same as the “reasonable belief” standard articulated in the proposed regulations. The Treasury refused to incorporate reliance on generally accepted administrative or industry practice when establishing reasonable cause relief under Treas. Reg. § 1.6695-2(d)(5). Rather, it decided to stay with the authority provided under Treas. Reg. § 1.6662-4(d)(3)(iii). The government also declined to set out a particular level of due diligence that would satisfy the threshold, and cautions that “due diligence is only one of many factors.”

11. I.R.C. §§ 6707 and 6707A — IRS Issues Proposed Regulations on Reportable Transactions Forms; Requests Comments on Guidance re Listed Transaction Penalties

The IRS has issued proposed regulations (REG-160872-04) relating to American Jobs Creation Act amendments to I.R.C. § 6707 penalties for failure to timely file a return, or for filing a return with false or incomplete information in relation to reportable transactions. The proposed regulations provide that material advisers who complete the Material Advisor Disclosure Statement, Form 8918, to the best of their ability and knowledge, after the exercise of reasonable efforts to obtain information, will not be considered to have filed an incomplete Form 8918. Under the proposed regulations, a Form 8918 that fails to include information required and contains a statement that the omitted information will be provided upon request will be considered intentionally incomplete and subject to increased penalty. In the case of a listed transaction, the failure to timely file a true and complete return will not be considered intentional if the adviser remedies the failure by filing a “true and complete” return before the earlier of the date that any taxpayer files a Form 8886 identifying the material adviser with respect to the reportable transaction at issue, or the date the IRS contacts the material adviser concerning the reportable transaction.

The IRS also has requested public comment on information collections under Rev. Proc. 2005-51, 2005-2 C.B. 296, which provides guidance on the payment and disclosure of penalties related to an individual’s participation in transaction listed by the IRS as tax-avoidance schemes. Comments are due by February 2, 2009. The notice and request for comments was published in the Federal Register on Dec. 2 (F.R. Vol. 73, No. 232).

12. Court Issues Injunction Barring Insurance Company from Collecting from SILO Transaction

In *Hoosier Energy Rural Electric Cooperative Inc. v. John Hancock Life Ins. Co.*, Dkt. No. 1:08-cv-1560-DFH-DML (S.D. Ind. Nov. 25, 2008), the United States District Court for the Southern District of Indiana entered a preliminary injunction barring John Hancock Life Insurance Company from immediately collecting millions in connection with a sale-in, lease-out (SILO) transaction that the company entered into with Hoosier Energy Rural Electric Cooperative Inc. and other entities. The court

noted that, although all parties to the transaction have been making payments required under the contracts, “the transaction is now in crisis because credit rating agencies have downgraded the credit ratings of one of the parties.” The case “provides a case study of some of the worst aspects of modern finance,” according to the court, which described the SILO transaction as “a blatantly abusive tax shelter.” In addition to entering a preliminary injunction, the court found that further proceedings on the issue of appropriate security for the injunction are necessary and that discovery should proceed immediately. The court also noted that its findings of fact and conclusions of law are tentative “to an unusual degree” because they are the result of an expedited process.

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