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TAX ISSUES SUMMARY

January 30, 2009

HIGHLIGHTS:

I.R.C. § 104 — Critical Illness Payments Made Under a Life Insurance Contract Rider that Reduce the Death Benefit of the Contract Are Excludable from Income

In PLR 200903001 (Oct. 14, 2008), the IRS ruled that payments made under a life insurance contract rider when the insured becomes critically ill, which reduce the death benefit of the contract, will be excluable from the recipient's gross income under I.R.C. § 104(a)(3). *See* Policyholder Issues.

I.R.C. § 6111 — IRS Designates the Use of Domestic Partnerships to Exclude Subpart F Income as Transactions of Interest

The IRS designated as "transactions of interest" arrangements in which a taxpayer interposes a domestic partnership in a controlled foreign corporation (CFC) structure to prevent inclusion of subpart F income. *See* Company Issues.

LEGISLATION

In General — Congress Proceeds with Tax Stimulus Packages

In the past week, both the House Ways and Means Committee and the Senate Finance Committee each marked up and passed stimulus tax packages (the cost of the tax provisions being between $300-350 billion); two days ago, the House passed the stimulus package, with no Republican support, and no changes to the tax provisions. Both packages provide that companies (including life insurance companies) can elect to carry back business net operating losses (NOLs) for any taxable year either beginning in 2008 or 2009, or ending in 2008 or 2009, for up to five years. Unlike the House package, the Senate would not require the amount of the NOLs available for the extended carryback period to be

reduced by 10%. Both packages make companies receiving assistance through the Treasury Department's Troubled Asset Relief Program ineligible for any loss carryback beyond two years, and would block Treasury's relaxation for merging banks of the I.R.C. § 382 limits on built-in losses. Another departure from the House is that the Senate package includes a one-year AMT patch for 2009.

The Senate stimulus package is expected to come up for a vote next week, with consideration of additional amendments to make the bill more business friendly. It is not clear whether such changes will garner any Republican support so that final vote for the package is more bi-partisan. Assuming the Senate passes its stimulus bill next week, conference negotiations can be expected to start the following week, with a final bill for the President to sign before the end of February.

POLICYHOLDER ISSUES

1. I.R.C. § 61 — IRS Rules that Utility's Segregated Fund Is Not Includable in Gross Income

In PLR 200852002 (Sept. 25, 2008), the IRS ruled that amounts held by a public utility company in a segregated account, consisting of gain from the sale of property and from nuclear decommissioning funds, are not includable in gross income under I.R.C. § 61. In the facts of the ruling, the taxpayer is a public electric utility, and is the wholly-owned subsidiary filing a consolidated return with an affiliated group of companies. The taxpayer requested a ruling on an Asset Sale Agreement (ASA) entered into with a buyer. The buyer agreed to purchase Unit 1 and Unit 2 of LX, which was owned by the taxpayer. The taxpayer represented to the state regulatory body that the sale would benefit its customers. The state regulatory body approved the sale, after striking an agreement with the taxpayer that any book gain on the sale as well as any excess decommissioning proceeds would accrue to the benefit of taxpayer's customers. To carry out this part of the agreement, the taxpayer transferred the sale proceeds to a segregated bank account. The taxpayer requested rulings that the portion of the remaining segregated fund amount consisting of the book gain from the sale of LX, plus the gain portion of the decommissioning funds, less certain transaction costs, and accrued interest, are not includable in the taxpayer's gross income. The IRS, basing most of its reasoning on case law, ruled that the amount in the segregated fund is not includable in gross income because there is no evidence of any economic benefit to the taxpayer from the fund.

2. I.R.C. §§ 72, 401, 403, 408, 408A, and 457 — Treatment of Existing Insurance Contracts Not Affected by Merger of Life Insurance Companies

In PLR 200903106 (Oct. 24, 2008), the IRS ruled that the merger of two mutual life insurance companies and the resulting assumption by the surviving company of liabilities under existing life insurance, annuity, and other insurance contracts issued by the other company will not cause such

contracts, whose terms and conditions remain the same, to be treated as newly issued or otherwise cause a change in their treatment, as resulting in an actual or deemed distribution under I.R.C. §§ 72, 401(a), 403(b), 408, 408A, and 457.

3. I.R.C. § 104 — IRS Rules Settlement Proceeds for Personal Injury Claims Excludable

In PLR 200903073 (Oct. 9, 2008), the IRS ruled that proceeds received in settlement of litigation against a drunk driver and his business qualify for exclusion from gross income under I.R.C. § 104(a)(2), to the extent they relate to personal physical injury and sickness claims. Included in the excluded funds are amounts paid for past and present medical expenses, future medical expenses, pain, suffering, and lost earnings. Proceeds from the settlement allocated to other claims, such as punitive damages, are includable in the taxpayer's income under I.R.C. § 61. The IRS did not offer an opinion on the proper allocation of the settlement proceeds between excludable and includable amounts.

4. I.R.C. § 104 — Critical Illness Payments Made Under a Life Insurance Contract Rider that Reduce the Death Benefit of the Contract Are Excludable from Income

In PLR 200903001 (Oct. 14, 2008), the IRS ruled that payments made under a life insurance contract rider when the insured becomes critically ill, which reduce the death benefit of the contract, will be excluable from the recipient's gross income under I.R.C. § 104(a)(3). The contract, which the issuing company represented as qualifying under I.R.C. § 7702, had a rider under which the owner could make an election to accelerate the receipt of all or a portion of the death benefit under the contract if the person insured thereunder becomes critically ill. The rider would pay a benefit to the policy owner during the insured's life time if the insured is diagnosed by a physician as having a qualifying covered condition. The covered conditions are defined in the rider. Payment of the benefit reduces the death benefit payable under the contract. The contract terminates if the death benefit payable is reduced to zero upon payment of the covered condition benefit. The ruling noted that I.R.C. § 104(a)(3) provides that, except in the case of amounts attributable to (and not in excess of) deductions allowed under I.R.C. § 213 (relating to medical expenses) for any prior taxable year, gross income does not include amounts received through accident or health insurance for personal injuries or sickness. It concluded, based on the representations and the authority so cited, that the rider will be treated as accident or health insurance and benefits received under the rider will be excludable from the recipient's gross income under I.R.C. § 104(a)(3), as long as the benefits are attributable to the recipient's after-tax contributions.

5. I.R.C. § 403 — Timing of Determinations Program for Tax-Sheltered Annuities Criticized

At a recent conference of the American Society of Pension Professionals and Actuaries a representative of IRS' Tax-Exempt and Government Entities Division said the revenue procedure describing the I.R.C. § 403(b) plan determination letter process will borrow heavily from Rev. Proc. 2005-16, 2005-10 I.R.B. 674, and that the determination letter program for I.R.C. § 403(b) plan

documents will initially only accept master and prototype plans. The IRS had initially said that final regulations for I.R.C. § 403(b) would take effect January 1, 2009, and would require plan sponsors to maintain plan documents. The IRS then released Notice 2009-3, 2009-2 I.R.B. 250, extending the date of compliance for one year because sample plan language and a determination letter program had not been developed. The I.R.C. § 403(b) program is now predicted for the end of the first quarter of 2009.

6. I.R.C. § 457A — IRS Provides Guidance on New Deferred Compensation Statute

In Notice 2009-8, 2009-4 I.R.B. 347, the IRS provided guidance on when employee compensation paid into a nonqualified deferred compensation plan (NDCP) is includable in a taxpayer's gross income under the new I.R.C. § 457A. This notice was issued in order to identify which types of NDCPs are subject to I.R.C. § 457A and whether the plan sponsor will be considered a nonqualifying entity. The notice contains many illustrative examples to help clarify how the new code section will be applied. The IRS and Treasury anticipate issuing further guidance, and request comments on several topics. No date is listed for when comments should be received.

COMPANY ISSUES

1. I.R.C. § 301 — Proposed Regulations on Allocation, Basis Recovery

The IRS issued proposed regulations (REG-143686-07) on the allocation and recovery of basis in redemptions of corporate stock governed by I.R.C. § 301. The regulations are designed to produce consistent results among economically similar transactions relating to stock basis recovery and stock basis identification. The IRS said the primary objective of the new regulations is to provide a single model for stock basis recovery by a shareholder that receives a constructive or actual distribution to which I.R.C. § 301 applies, and a single model for sale and exchange transactions under I.R.C. § 302(a). Comments and public hearing requests on the proposed regulations are due by April 21.

2. I.R.C. §§ 302 and 304 — Tax Court Rules Subsidiary Is the Only Shareholder Whose Interest in the Issuing Corporations Must Be Tested

In *Merrill Lynch & Co., Inc. & Subsidiaries v. Commissioner*, No. 18170-98 (Dec. 30, 2008), the Tax Court held that only the redemption of stock by a subsidiary was properly treated as a distribution in exchange for stock under I.R.C. § 302(a) because the subsidiary's interest was completely terminated. It reasoned that I.R.C. §§ 302 and 304 operate to determine the tax consequences to the recipient of a corporate distribution; I.R.C. §§ 302 and 304 apply only to the shareholder who receives proceeds of a cross-chain sale in exchange for stock. I.R.C. § 302(b) cannot be applied to a shareholder who indirectly or constructively holds stock but has not transferred any stock or received the proceeds of a sale of stock. Accordingly, the court did not agree with the taxpayer's argument that the I.R.C. § 302(b)(3) test for complete termination of the subsidiary's interest in the issuing corporations requires consideration of the

parent corporation's ownership interest in the issuing corporations. It concluded that the parent corporation is not entitled to dividend treatment since it constructively owned 100 percent of the issuing corporations' stock before and after the transaction took place.

3. I.R.C. § 482 — IRS Issues Cost-Sharing Regulations

The IRS issued long-awaited proposed (REG-144615-02), temporary and final (T.D. 9441) regulations on methods to determine taxable income in connection with a cost-sharing arrangement. Making several significant changes to existing rules, the new rules address several issues that have arisen in administering regulations proposed in 2005, including whether and how the regulations conform to the arm's-length standard and the commensurate-with-income requirement added in 1986. The temporary regulations provide further guidance on the evaluation of the arm's-length results of cost-sharing transactions and platform contribution transactions. They also address the material functional and risk allocations in the context of a cost-sharing arrangement, as well as providing taxpayers with greater flexibility in designing certain aspects of such arrangements. Despite criticism from commentators on the 2005 proposed regulations, the regulations retained the "investor model," noting that "the upfront evaluation pursuant to the investor model of expected returns to particular risks assumed in intangible development and exploitation under the facts and circumstances is key to ensuring consistency of the results of a [cost sharing arrangement] with the arm's length standard."

4. I.R.C. § 807(f) — IRS Appeals Settlement Position Posted on Change in Basis of Reserves

In late December 2008, the IRS Appeals posted its settlement guideline with respect to I.R.C. § 807(f), saying that any change in an insurance reserve item not caused by a correction of a nonrecurring mathematical or posting error is a change in basis to be amortized over a 10-year period starting the subsequent tax year. The guideline said that an Appeals Officer should (1) determine if the change in reserve occurred because of a change in an actuarial assumption or correction of an error, (2) verify that the proposed adjustment is the difference between the ending reserves calculated under the new and the old method (so the adjustment is attributable to contract issued before the start of the taxable year), and (3) establish that the adjustment is proposed for the correct year. This guideline statement is generally consistent with Rev. Rul. 94-74, 1994-2 C.B. 57.

5. I.R.C. § 6111 — IRS Designates the Use of Domestic Partnerships to Exclude Subpart F Income as Transactions of Interest

The IRS designated as "transactions of interest" arrangements in which a taxpayer interposes a domestic partnership in a controlled foreign corporation (CFC) structure to prevent inclusion of subpart F income. IRS and Treasury Department believe that this type of transaction has the potential for tax evasion or avoidance, but lack the information to determine that it should be identified as a tax avoidance transaction. In Notice 2009-7, 2009-3 I.R.B. 312, the IRS gives the specific example of a U.S. taxpayer owning two CFCs that are partners in a domestic partnership whose income is not subject to U.S. taxes.

The domestic partnership then owns a third CFC that generates subpart F income. The U.S taxpayer claims the subpart F income from the third CFC results in no income inclusion to taxpayer under I.R.C. § 951. The taxpayer's position is "contrary to the purpose and intent of the provisions of subpart F of the Code." These transactions are identified as transactions of interest effective December 29, 2008. Persons entering into these or similar transactions on or after November 2, 2006, must disclose the transaction as participants in accordance with Treas. Reg. § 1.6011-4. Material advisors who made a tax statement regarding these or similar transactions on or after November 2, 2006, are subject to disclosure and list maintenance obligations pursuant to I.R.C. §§ 6111 and 6112. Failure to disclose will result in penalties.

6. I.R.C. § 7701 — ABA Tax Section Seeks Guidance Clarifying Protected Cell Company Notice and Treatment of LLC Series

In January, 2008, the IRS issued Rev. Rul. 2008-8, 2008-5 I.R.B. 340, and Notice 2008-19, 2008-5 I.R.B. 366, providing guidance on the standards for determining whether an arrangement between a participant and a cell of a protected cell company constitutes insurance for federal income tax purposes, and whether amounts paid to the cell are deductible as insurance premiums. In response to the IRS' request for comments, the American Bar Association (ABA) Tax Section filed a January 5, 2009 comment letter and requested that IRS give guidance on the tax treatment a limited liability company (LLC) series, confirming that each series would be treated as a separate business entity if certain minimum requirements are fulfilled. The letter recommended that the characterization of the LLC as a separate entity for federal tax purposes also depend on whether minimum requirements to be a business entity separate from its series are met by the LLC. The letter also said that the classification guidance should be applied prospectively.

7. I.R.C. § 7702 — Company Granted Waiver Where Amendments to Life Insurance Contracts Caused Them to Fail

In PLR 200901028 (Sept. 29, 2008), IRS granted a waiver to a life insurance company for policies that failed the federal tax definition of life insurance where the failure was caused by amendments developed for certain contracts to accommodate corporate policyholders' requests to mitigate or eliminate the charge to their earnings that resulted in initial policy years when cash values were less than premiums paid. The company assumed that the amount paid at surrender under the amendments was not included in the cash surrender value of the contract, but discovered that the IRS considered the additional amounts payable upon surrender under the amendments to be included in cash surrender value for purposes of meeting the cash value accumulation test or the guideline premium/cash value corridor test. The IRS concluded that the company took reasonable steps to remedy the error (i.e. replacement of the amended contracts with new contracts in compliance with I.R.C. § 7702), and that the failure of the contracts to meet the I.R.C. § 7702 tests was due to reasonable error. Neither the contracts' failure, nor any corrective action will have any effect on the dates the contracts were issued, entered into, or purchased for purposes of I.R.C. §§ 72, 101(j), 264, 7702 or 7702A. The contracts will not be subjected to retesting or restarting of a new test period under I.R.C. §§ 264(d), 7702(f)(7) or 7702A(c).

8. *Textron* Court Upholds Workpaper Protection

In *United States v. Textron*, No. 07-2361 (Jan. 21, 2009), the U.S. Court of Appeals for the First Circuit upheld a district court finding that Textron's tax accrual workpapers are protected from discovery by the IRS. However, the court vacated the lower court's determination that the work-product protection was not waived by disclosure to an outside auditor. The workpapers at issue were prepared pursuant to financial reporting requirements and provided to the taxpayer's accountants, but also served as a litigation hazards summary. The court said that "the presence of a business purpose does not defeat work-product protection." At the heart of the case was the contention by the government that the workpapers were not protected by privilege because they had been disclosed to the taxpayer's auditors. The First Circuit noted that the factual record of the lower court was unclear on whether the accountants would have to produce information relating to the workpapers in response to a summons. The case was remanded to the district court in order to get a determination on that issue.

9. IRS Releases Updated No-Rule List

The IRS issued Rev. Proc. 2009-3, 2009-1 I.R.B. 107 and Rev. Proc. 2009-7, 2009-1 I.R.B. 226, updating the list of areas in which the IRS will not issue letter rulings or determination letters. Among the areas listed are:

- I.R.C. § 61 — Whether a split-dollar life insurance arrangement is "materially modified" within the meaning of Treas. Reg. § 1.61-22(j)(2)
- I.R.C. § 79 — Whether a group insurance plan for 10 or more employees qualifies as group-term insurance if the amount of insurance is not computed under a formula that would meet the requirements of Treas. Reg. § 1.79-1(c)(2)(ii) if the group consisted of fewer than 10 employees
- I.R.C. § 101 — Whether there has been a transfer for value for purposes of I.R.C. § 101(a) in situations involving a grantor and a trust when (i) substantially all of the trust corpus consists or will consist of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has the power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has the power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (iv) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under I.R.C. §§ 673 to 677
- I.R.C. §§ 101, 761 and 7701 — Whether, in connection with the transfer of a life insurance policy to an unincorporated organization, (i) the organization will be treated as a partnership under I.R.C. §§ 761 and 7701, or (ii) the transfer of the life insurance policy to the organization will be exempt from the transfer for value rules of I.R.C. § 101, when substantially all of the organization's assets consist or will consist of life insurance policies on the lives of the members.

10. FASB, IASB Deliberating on How to Account for Insurance Contracts

On January 9, the Financial Accounting Standards Board (FASB) heard analysis of comments received on proposed new approaches to improved accounting for insurance contracts. This hearing comes as part of a complex standard-sharing project that the FASB decided to take on last October. The International Accounting Standards Board (IASB) conducted the first phase of the project in 2004, and came up with an interim set of rules with shortcomings acknowledged by rulemakers. The IASB and FASB plan to work together to issue draft standards by the end of the year.

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