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TAX ISSUES SUMMARY

February 27, 2009

***HIGHLIGHTS*:**

I.R.C. § 7702 — Life Insurance Contracts with Attached Wellness Riders Meet the Cash Value Accumulation Test, the Guideline Premium Limitation, and the 7-Pay Test

In PLR 200906001 (Oct. 17, 2008), IRS concluded that life insurance contracts with attached wellness riders could meet the life insurance contract qualification requirements, as well as the 7-pay test. *See* Policyholder Issues.

I.R.C. § 1504 — Life Insurance Company in Run-Off Is Eligible for Inclusion in Life-Nonlife Consolidated Return Group

In PLR 200905020 (Oct. 21, 2008), IRS held that a life insurance company that has ceased issuing policies has been engaged in the active conduct of a trade or business and could be included in a life-nonlife consolidated return. *See* Company Issues.

LEGISLATION

1. The American Recovery and Reinvestment Act for Economic Stimulus

President Obama signed into law on February 17 the American Recovery and Reinvestment Act of 2009, which is estimated to be a $787 billion stimulus package to help lift the economy out of recession. The stimulus package contains approximately $301 billion worth of tax cuts for individuals and businesses, including tax-advantaged bonds to help encourage investments in school construction, renewable energy projects, and other infrastructure projects. Only three Senate Republicans voted in favor of the package; Republicans generally criticized the bill as overspending and not having enough tax cuts. President Obama has been “selling” the package to the American people as a “balanced” approach, appropriately breaking from the past and focusing its benefits on the middle-class rather than the wealthiest Americans.

The new law provides a five-year net operating loss carryback provision for businesses with less than $15 million in annual gross receipts, and provides incentives for investments through a one-year extension of I.R.C. § 168 bonus depreciation and through increased I.R.C. § 179 expensing. It repeals Notice 2008-83, 2008-42 I.R.B. 905, which allowed banks freedom to use built-in losses and losses associated with bad debts before and after acquisitions under I.R.C. § 382, for deals struck on or after January 16, 2009. Such repeal was estimated to raise $6.98 billion over 10 years. The law also amended I.R.C. § 382 to allow companies that may be required to restructure as part of an agreement for a federal loan to do so without triggering a new tax liability for the company.

2. Fiscal Responsibility Summit Called; Administration Budget Released

Long-term tax reform was not one of the primary goals identified for consideration during the White House fiscal summit on February 23. Although President Obama indicated that he was interested in pursuing a simpler tax code, the Administration has no ideas or concrete proposals for broad tax reform. Obama said that he would be in favor of cutting the corporate tax rate if the cost could be offset by eliminating tax loopholes used by many companies. On the other hand, there were strong signals the health care reform was a top priority. If the Obama Administration's main concern is health care, many analysts see great overlap of that with tax reform. For example, as a cost-savings measure encouraging employees to choose less expensive health coverage, some portion of employers' health care contributions might be included in income for the employee. After the initial remarks, there were five break out sessions focusing on the health care, taxes, Social Security, contracting and procurement, and the budget. Generally, the fiscal responsibility summit might be viewed as ground work for President Obama's speech on February 24 and the Administration's budget released on February 26.

POLICYHOLDER ISSUES

1. I.R.C. § 61 — Attorneys' Fees Paid from Settlement of Opt-Out Class Action Lawsuit Are Not Includable in Gross Income of the Class Members

In PLR 200906010 (Oct. 24, 2008) and PLR 200906012 (Oct. 24, 2008), the IRS determined that attorneys' fees paid to counsel representing employees of the defendant in a successful class-action lawsuit for vacation pay are not includable in the gross income of the class members (or the named class representatives), and are not subject to federal employment taxes or information reporting to the class members or representatives under I.R.C. § 6041.

2. I.R.C. § 419 — Court Finds that State Law Fraud, Misrepresentation Claims Not Preempted by ERISA

In *Westfall v. Bevan*, No. 3:08-cv-0996-D (N.D. Texas Jan. 15, 2009), the U.S. District Court for the Northern District of Texas found that state law fraud and negligent misrepresentation claims against the Millennium Multiple Employer Welfare Benefit Plan ("Plan") were not preempted by the Employee Retirement Income Security Act (ERISA). In the facts of the case, a business (Westfall Constructors Ltd.) sued the benefit plan and other individuals and organizations involved with it, claiming fraud and negligent misrepresentation, among other complaints. One defendant, an insurance company, told

Westfall that the Advantage DBO plan offered attractive long-term returns and complied with I.R.C. § 419, which allows full deductions of contributions. The DBO plan was later dissolved, and Westfall's investments transferred to the Plan. Four years after the transfer, the IRS ruled in a private letter ruling that the Plan did not qualify under I.R.C. § 419. The chairman of the Plan committee advised investors to amend their tax returns to reflect the conclusion made by the ruling. Westfall claimed that it has had to pay substantial tax penalties and interest following an IRS audit of the DBO plan.

The defendants in the case contend that the Plan is an employee welfare benefit plan and a multiple employer welfare arrangement under ERISA, and that Westfall was a covered employer. The court found that Westfall's claims were not preempted by ERISA, and remanded the case back to state court for a ruling on the merits of the claims.

3. I.R.C. § 7702 — Life Insurance Contracts with Attached Wellness Riders Meet the Cash Value Accumulation Test, the Guideline Premium Limitation, and the 7-Pay Test

In PLR 200906001 (Oct. 17, 2008), IRS concluded that life insurance contracts with attached wellness riders could meet the life insurance contract qualification requirements, as well as the 7-pay test. The wellness rider offers wellness benefits and rewards, including a discount on the current cost of insurance charges for contracts that insure individuals who satisfy a certain criteria. A contract designed to satisfy the cash value accumulation test of I.R.C. § 7702(b) to which a wellness rider is attached will not fail to satisfy the test solely because an adjustment is not made under I.R.C. § 7702(f)(7) to treat the contract as a newly issued contract each time the company declares or credits this COI discount. However, the ruling indicates that the company must use the reduction methodology upon contract issuance in calculating the net single premium to be paid at each duration to fund future benefits under a contract pursuant to I.R.C. § 7702(b)(1). Likewise, a contract designed to satisfy the guideline premium limitation of I.R.C. § 7702(c) and the cash value corridor of I.R.C. § 7702(d) to which the wellness rider is attached will not fail to meet the limitation solely because an adjustment is not made upon credit of a COI discount pursuant to I.R.C. § 7702(f)(7). The company must use the reduction methodology upon issuance in calculating the guideline single premium within the meaning of I.R.C. § 7702(c)(3) and the guideline level premium of withing the meaning of I.R.C. § 7702(c)(4). Finally, the ruling concluded that a contract to which the wellness rider is attached will not fail to satisfy the seven-pay test set forth in I.R.C. § 7702A(b) solely because the company does not treat the contract as having undergone a materials change or otherwise as newly issued when the company declares a COI discount.

COMPANY ISSUES

1. I.R.C. § 304 — IRS Issues Regulations Tightening Regime on Stock Transfers to Foreign Firms for Repatriation Deals

The IRS has issued temporary and final regulations (T.D. 9444) which tighten the regime applying I.R.C. §§ 367(a) and 367(b) to certain transfers of stock to foreign corporations under I.R.C. § 304. The regulations are intended to stop a transaction that involves a U.S. parent selling a subsidiary to another subsidiary, the buyer being foreign. Under the old regime, some taxpayers treated the

repatriated cash arising out of the transaction as non-taxable because it represented a recovery of basis. Companies were taking the position that the basis of the acquired target stock could be used to absorb the repatriated stock. The new rules are designed to address this issue and prevent the tax-free transfer of cash from overseas.

2. I.R.C. § 807 — Prevailing State, and Applicable Federal Interest Rates Prescribed for 2008 and 2009

Rev. Rul. 2009-3, 2009-5 I.R.B. 382, supplements the schedules of prevailing State assumed interest rates that were originally released in Rev. Rul. 92-19, 1992-1 C.B. 227 by providing such rates for taxable years beginning after December 31, 2007, for insurance contracts issued in 2008 and 2009. It likewise supplements Rev. Rul. 92-19 by providing the applicable Federal interest rates under I.R.C. § 807(d) for 2008 and 2009.

3. I.R.C. § 807 — Funding Agreements Give Rise to Reserve Items, Though They May Be Characterized as Debt

In PLR 200908019 (Nov. 17, 2008), IRS determined that funding agreements proposed to be offered by a life insurance company to institutional investors will give rise to a reserve under I.R.C. § 807(c)(3) as amounts held to satisfy annuity contract obligations that do not involve life accident or health contingencies. The IRS, in the interest of sound tax administration, declined to rule on whether the amounts credited by the company to the accumulation fund under the agreement constitute payments of interest for purposes of the portfolio interest exception under I.R.C. §§ 871 and 881. IRS did state that, notwithstanding that the funding agreement qualifies for reserve treatment, the agreement is a debt instrument under which the insurer pays interest.

4. I.R.C. § 831 — Foreign Company Participating in a Foreign Insurance Pool Qualifies as an Insurance Company Eligible for an I.R.C. § 953(d) Election

In PLR 200907006 (Nov. 10, 2008), the IRS determined that various insurance coverages offered to U.S. corporations and partnerships by a foreign company, which passes the risks to a foreign reinsurance pool constitutes insurance for federal income tax purposes, provided the company is adequately capitalized. It also concludes that the foreign company is in the business of issuing insurance and reinsurance contracts, and will be treated as an insurance company taxable under I.R.C. § 831 eligible for an I.R.C. § 953(d) election as long as it meets the definition of I.R.C. § 831(c). Finally, it concludes that consideration made by its insureds to the company is eligible to meet the definition of insurance premiums as described in Treas. Reg. § 1.162-1(a).

5. I.R.C. § 1504 — Life Insurance Company in Run-Off Is Eligible for Inclusion in Life-Nonlife Consolidated Return Group

In PLR 200905020 (Oct. 21, 2008), the IRS held that a life insurance company that has ceased issuing policies has been engaged in the active conduct of a trade or business and could be included in a life-nonlife consolidated return. Although the life insurance company has ceased issuing new policies, it would take a number of years to run off its existing policies. The company had been acquired by a

common parent of a life-nonlife consolidated return group and was permitted to file a consolidated return because, as an incoming subsidiary, it is an includable corporation under I.R.C. § 1502 regulations.

6. I.R.C. §§ 6402 and 6621 — Court Rules that IRS' Crediting of Tax Amounts Not Limited by Interest Netting Application

In *General Electric Co. v. United States*, No. 06-489T (Fed. Cl. February 13, 2009), the U.S. Court of Federal Claims held that the IRS' crediting of a tax overpayment against outstanding underpayment amounts was proper and was not limited by provisions regarding the application of interest netting. In the facts of the case, the IRS, in 1992, notified General Electric Co. ("GE") that the amount paid for its 1979 income tax was deficient. GE filed a petition for redetermination with the U.S. Tax Court. In 1999, the Tax Court held that GE had overpaid in 1979 by an excess of $37 million. At the same time, GE and the IRS agreed that GE was liable for income tax deficiencies for tax years 1986 and 1987 in the amounts of $70.6 million and $401.8 million, respectively. In December of 1999, GE requested that interest netting be applied to periods of overlapping payments and underpayments. In July 2000, the IRS performed interest computations for the years at issue. The IRS then credited the 1979 account with $85 million. This resulted in overpayments being credited to the 1986 and 1987 accounts in partial satisfaction of the underpayment. GE claimed that the overpayment to the 1979 account was improper, and was entitled to a refund of overpayment for 1979 in the amount of $37 million plus interest.

The IRS argued that it credited the 1979 overpayment against the later underpayments as permitted by I.R.C. § 6402(a). The court noted that I.R.C. § 6621(d), which institutes a net interest rate of zero on simultaneous overpayments and underpayments, is more advantageous because corporate taxpayers pay a higher rate of interest on their underpayments than the interest rate they earn on their tax overpayments. GE argued that there was a difference between interest netting and crediting, and that the code sections permitting netting should prevail. The court did not agree with GE's argument, finding that the two code sections were not in conflict with each other. Additionally, the court found that the IRS had the authority and discretion under I.R.C. § 6402(a) to credit the 1979 overpayment against the 1986 and 1987 underpayments and to compute interest retroactively.

7. I.R.C. §§ 6402 and 6621 — IRS Provides Interest Netting Guidance for Consolidated Groups

In a pair of emails, ECC 200908038 (Nov. 18, 2009) and ECC 200908040 (Nov. 18, 2008), the IRS answers questions related to interest netting for consolidated groups. Both emails have questions and answers regarding whether the new parent and/or the subsidiaries are liable for underpayments or entitled to overpayments that were left by the former parent, and whether and when there can be interest netting with respect to such underpayments and overpayments. The email concludes that in order to net interest as permitted under I.R.C. § 6621(d) depends on whether and when the members of the group can be considered the "same taxpayer."

8. NAIC Rejects Reserve Relief for Life Sector

On January 29, 2009, the National Association of Insurance Commissioners Executive Committee rejected a life insurance industry request to make immediate adjustments in existing NAIC solvency framework components that affect life insurers' capital and surplus requirements. In December, the American Council of Life Insurers asked for relief from overly conservative reserve requirements by calling for changes that would "free up about 6% of insurer capital walled from use as a result of current reserving, accounting and investment standards." The NAIC Capital and Surplus Relief Working Group recommended adoption of a package of relief measures which included 6 of 9 of the ACLI proposals, but the Committee refused to adopt the package with a vote of 16-1. NAIC expects to consider the proposed changes in the future, but not on an emergency basis.

9. FASB and IASB to Start Work to Improve Accounting

The Financial Accounting Standards Board (FASB) is going to start work in the coming weeks on a new, long-term effort in partnership with its international counterpart, the International Accounting Standards Board (IASB), to improve and make more consistent accounting in the increasingly global business of insurance. At meetings in late February, the FASB and IASB focused on five "candidates for being selected as measurement approaches for insurance contracts." The areas being worked on are (1) the current exit value, (2) current fulfillment value "including a risk margin based on the cost of bearing risk," (3) current fulfillment value "including a risk margin based on the cost of bearing risk, and separate from the risk margin, an additional margin as the difference between the premium and the expected value of the cash flows plus the margin for bearing risk," (4) current fulfillment value "including a single margin calibrated at inception to the premium," and (5) "unearned premium for the pre-claims liability of short-duration contracts." At a recent meeting, FASB agreed to explore an approach where an insurance contract is measured at a current fulfillment value rather than a fair value under FAS 157 or an exit value. Thus begins but does not conclude its deliberation on a measurement objective for insurance liabilities. A meeting observer from the International Accounting Standards Board noted that a consensus on the issue was also not reached during IASB's board meeting last week. The FASB and IASB hope to have a final, aligned standard by 2011.

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