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TAX ISSUES SUMMARY

March 31, 2009

***HIGHLIGHTS*:**

I.R.C. § 108(i) — Treasury Plans to Issue Guidance on Cancellation of Debt Provision in Stimulus Package

A Treasury representative has indicated that the Office of Tax Legislative Counsel is working on corporate guidance on a cancellation of debt ("COD") income provision signed into law as part of the recent stimulus package. Questions being considered are (1) whether taxpayers making the new election should be required to increase their earning and profits during the year the COD transaction occurred, as is required in similar transactions, and (2) whether to provide relief for taxpayers who elect the deferral and then go out of business, transferring all their assets to a successor and triggering an acceleration of the COD income deferral under the general provisions of the statute. *See* Company Issues.

***Textron* Case to Be Given an En Banc Rehearing**

The First Circuit has vacated the panel decision in *United States v. Textron*, No. 07-2631 (1st Cir. Mar. 25, 2009), and granted the Government's motion for an en banc rehearing. The panel had held that the corporation's tax accrual workpapers are protected by the work product privilege and that the business purpose of the documents did not defeat the privilege. *See* Company Issues.

LEGISLATION

1. In General

As Congress approaches its Spring recess at the end of this week, both the House and the Senate will take up their own version of the Administration's proposed budget plan. Both would restore the two top individual income tax brackets to pre-2001 rates, beginning in 2011 (when the 2001 tax cuts expire),

for individuals earning more than $200,000 and couples earning more than $250,000. Both plans would patch the alternative minimum tax ("AMT"), with the Senate assuming no offsetting revenue and the House assuming a pay-as-you-go requirement. Both plans provide for a freeze of the estate tax provisions at 2009 levels (i.e., an exemption amount of $3.5 million and a maximum rate of 45 percent), as well as extensions of middle class tax relief in the form of the 10-percent tax bracket, marriage penalty relief, the child tax credit and small business tax relief. A major difference in the House and Senate budget packages is that the House plan provides for reconciliation language relating to health care reform and the Senate provides no reconciliation provisions (it is generally thought that Senate Majority Leader Reid cannot get the votes to pass the budget if it has any reconciliation instructions).

Although the budget plans do not contain specifics regarding tax provisions, Senator Baucus (D-Mont.), Chairman of the Finance Committee, introduced a $2.3 trillion tax cut package that would make the 2009 AMT patch permanent, as well as the 10-, 25- and 28-percent tax brackets. It would also make permanent (1) the 2009 estate tax provisions, (2) the reduced long-term capital gains and dividend tax rates, (3) the inflation-indexed $3,000 income threshold for the refundable child tax credit, (4) the 2009 dependent- and child-care credit, (5) the "marriage penalty" relief, (6) the current adoption credit, and (7) the 45-percent earned income tax credit and higher phase-out ranges enacted under the American Recovery and Reinvestment Act of 2009. The package contains no suggested revenue offsets. One might expect the Ways and Means Committee to be looking at similar tax provisions as the year unfolds.

2. Tax Reform Task Force Announced

In the midst of all the budget discussions, the Administration announced plans to create a White House task force to recommend ways to simplify the tax code and reduce tax evasion. More specifically, the task force will be asked to focus on recommendations to reduce the "tax gap" and make various credits in the code more consistent, but also will be asked to not include any tax increases during 2009 and 2010 in their recommendations, nor any tax increases thereafter for those making less than $250,000 per year. Because the idea of a tax reform task force is not unlike the bi-partisan tax reform panel established by President Bush in 2005, there is some speculation that the announcement of the task force, which will be called on to make a report in December 2009, is just a means to defer the tax reform discussion until the Administration has worked on its other priorities (e.g., health reform, energy/environment, etc.)

3. Grassley Would Provide Tax Benefit for the Purchase of Long-Term Care Insurance

Senator Grassley ®- Iowa) introduced a bill, the Long-Term Care Affordability and Security Act of 2009 (S. 702), that would permit employers to offer long-term care insurance as a benefit choice under I.R.C. § 125 cafeteria plans and flexible spending arrangements. The bill would permit employees to pay for long-term care insurance premiums and out-of-pocket expenses on a tax-deferred basis and, thus, encourage younger employees to buy long-term care insurance.

4. Stop Tax Haven Abuse Act Reintroduced

On March 2, Sen. Carl Levin (D-Mich.) introduced what he termed an "improved" version of the Stop Tax Haven Abuse Act (S. 506) that he had previously introduced in the Senate in February 2007. A companion bill (H.R. 1265) was introduced the same day in the House by Rep. Lloyd Doggett (D-Tex.). The new version includes provisions that would (1) treat foreign corporations that are publicly traded or have at least $50 million in assets, and the management and control of which is primarily in the United States, as domestic corporations for income tax purposes, (2) treat all U.S. dividend-based payments to non-U.S. persons as taxable income, and (3) expand IRS reporting requirements for passive foreign investment companies (PFIC) to include not only U.S. persons who own a PFIC but also those who have formed, sent assets to, received assets from, or benefitted from a PFIC. Provisions that were in the original version include authorizing special measures against foreign jurisdictions, financial institutions, and others that impede U.S. tax enforcement; requiring U.S. financial institutions to report accounts opened by foreign entities known to be beneficially owned by U.S. persons; and increasing the maximum fine on tax shelter promoters to 150 percent of their promoter fees.

POLICYHOLDER ISSUES

1. I.R.C. § 2511 — IRS Rules Premium Payments are Not Gifts

In PLR 200910002 (Sept. 30, 2008), the IRS ruled that payment of premiums by the settlors of a trust under a split-dollar life insurance arrangement will not result in a gift under I.R.C. § 2511. In the facts of the ruling, the married settlors of an estate created an irrevocable trust, and were named trustees. The trust purchased a second-to-die life insurance policy on the lives of the settlors, and proposed to enter into a split-dollar life insurance arrangement with the settlors. The trust will own the policy and pay an amount equal to the insurance company's current published premium rate for annually renewable term insurance generally available for standard risks while the settlors are both living. After the death of one settlor, the trust will pay an amount equal to the lesser of the applicable amount provided by relevant IRS guidance, or the insurer's current published premium rate. The settlors will pay the balance of the premiums and will be entitled to receive an amount equal to the greater of the cash value or premiums paid upon early termination of the death of the survivor. The IRS ruled that the premiums paid under the agreement by the settlors would not result in a gift or a deemed gift to the trust under I.R.C. § 2511. However, if some or all of the cash surrender value is used to fund the trust's obligation to pay premiums, the settlors will be treated as making a gift at that time. The IRS also ruled that the insurance proceeds payable to the trust would not be includable under I.R.C. § 2042 in the gross estate of either settlor.

2. I.R.C. § 7702 — IRS Clarifies Computational Rules for Life Insurance Companies

In PLR 200910001 (Mar. 6, 2009), the IRS ruled that the net single premium for meeting the cash accumulation test under I.R.C. § 7702(b) for a group flexible premium variable contract can be determined for each certificate by assuming that the face amount of each certificate is provided until age 100. The ruling noted that I.R.C. § 7702(e) provides computation rules for determining "future benefits"

to be taken into account in calculating the "net single premium," and provides that the maturity date of a contract is not earlier than attainment of age 95 by an insured, and not later than attainment of age 100. Based on the information provided by the taxpayer, the IRS determined that age 100 is the proper age to use for the case value accumulation test.

COMPANY ISSUES

1. I.R.C. § 72 — Tax Court Allows Tax Deferral of Gain in a Stock-for-Private-Annuity Exchange

In *Katz v. Commissioner*, T.C. Memo. 2008-269 (Dec. 3, 2008), the Tax Court held that the taxpayer was entitled to defer recognition of capital gain relating to the transfer of appreciated stock in exchange for a private annuity, and that he was not liable for accuracy-related penalties. The taxpayer, Katz, was founder of ELA and owner of all of ELA's stock. Katz entered into an agreement with UICI Acquisition Corp. to merge ELA into a newly created subsidiary of UICI. Katz received 470,708 shares of UICI stock for his ELA stock. Katz then purchased 200,000 UICI common stock put options from Merrill Lynch in exchange for 200,000 common stock call options to be exercised only on February 3, 2000. Katz entered into a single lump-sum private annuity contract with SJA, an unrelated corporation, and an assignment agreement with both Merrill Lynch and SJA where he transferred 200,000 shares of UICI stock and the put options to SJA. On February 3, SJA exercised the put options and delivered the UICI shares. Merrill Lynch erroneously deposited the proceeds totaling $4,617,841.00 into Katz's non-interest bearing Merrill Lynch account. On May 8, 2000, to correct the error, $3,817,841 was transferred from Katz's account to an accounted owned by SJA. Pursuant to the annuity contract, Katz kept $800,000 of the stock sale proceeds. Katz's basis in the UICI shares was $150,650, but he reported that his basis was $4,617,841 on his federal tax returns in an attempt to address the error. In 2005, IRS determined a $920,813 deficiency by Katz and an additional accuracy related penalty.

The Tax Court held that deferral of the recognition of capital gain with respect to the disposal of the 200,000 shares of UICI purchased by Merrill Lynch was entirely proper. Relying on Rev. Rul. 69-74, 1969-1 C.B. 43, the court quoted "the gain shall be reported ratably over the period of years measured by the annuitant's life expectancy and only from that portion of the annual proceeds which is includible in gross income by virtue of the application of Section 72." Katz was allowed to defer recognizing the gain until he receives the annuity payments. Note that the IRS had stipulated that it would not assert that the transaction was a sham or had been entered into for the purpose of avoiding federal income taxes, causing the court to note that the IRS had stipulated away the underpinnings for any form-over-substance argument.

2. I.R.C. § 108(I) — Treasury Plans to Issue Guidance on Cancellation of Debt Provision in Stimulus Package

A Treasury representative has indicated that the Office of Tax Legislative Counsel is working on corporate guidance on a cancellation of debt ("COD") income provision signed into law as part of the recent stimulus package. The provision, in I.R.C. § 108(I), allows corporations to defer COD income for up to five years. Apparently, a key question being considered is whether taxpayers making the new election should be required to increase their earning and profits during the year the COD transaction occurred, as is required in similar transactions. Another question is whether to provide relief for taxpayers who elect the deferral and then go out of business, transferring all their assets to a successor and triggering an acceleration of the COD income deferral under the general provisions of the statute.

3. I.R.C. § 3121 — Court Looks to Implementing Regulations Over Legislative History

In *United States v. Memorial Sloan-Kettering Cancer Center*, Doc. Nos. 07-9026 and 07-0949 (2d Cir. March 25, 2009), the Court of Appeals for the Second Circuit determined that two cases were wrongly decided in lower district courts, and remanded them for further proceedings on the issue of whether post-graduate medical residents can invoke the Federal Insurance Contributions Act ("FICA") tax exemptions allowed for "students." The lower courts each ruled that the residents were categorically ineligible for the exemption as a matter of law. Although the court does not cite the *Chevron* case, the court looked to the effective implementing regulations and the generality of their provisions as support for concluding that the statutory language could be interpreted broadly. The appeals court disagreed with the lower courts' reliance on legislative history, saying that looking to legislative history was unnecessary because, unambiguously, the statute did not categorically exclude the medical residents from the exemption granted to "students." In a footnote, the court noted that the IRS recently had amended the implementing regulations with respect to the student exception, providing clarifying examples that indicated that medical residents are excluded from the student exception. However, the court did not apply or consider the amended regulations because they were not effective for the taxable years in dispute. The Second Circuit remanded the cases back to the district courts for further proceedings consistent with its ruling.

4. *Textron* Case to Be Given an En Banc Rehearing

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5. Groups Fault SEC, FASB for Accounting-Related Responses to Economic Crisis

In a March 9 letter to Rep. Barney Frank (D-Mass.) and Rep. Spencer Bachus ®-Ala.), chairman and ranking Republican member of the House Financial Services Committee, respectively, a group of corporate trade groups strongly criticized federal securities regulators and the Financial Accounting Standards Board ("FASB") for not "fixing" the problems with fair value reporting, and to put an end to "the spiral of accounting-driven financial losses." The letter was sent by the U.S. Chamber of Commerce, American Bankers Association, American Council of Life Insurers, Financial Services Roundtable, various real estate and home builders groups, and the Council of Federal Home Loan Banks, among others. The letter says that though not the cause of it, the "pro-cyclical impacts of certain mark-to-market accounting principles have exacerbated" the financial crisis. The letter was written four days after the introduction of H.R. 1349, which would create a new federal accounting oversight board to clear FASB changes to accounting standards in light of their potential impacts on the U.S. economy and financial institutions, and urges that action be taken immediately rather than waiting until mid-year or year-end, as the more time that passes, the more accounting-driven financial losses will accumulate.

***IRS Circular 230 Disclosure*:**

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