SCRIBNER, HALL & THOMPSON, LLP

SUITE 1050
1875 EYE STREET, N. W.
WASHINGTON, D. C. 20006-5409

(202) 331-8585
FAX (202) 331-2032

THOMAS C. THOMPSON, JR.
MARK H. KOVEY
STEPHEN P. DICKE
PETER H. WINSLOW
SUSAN J. HOTINE
BIRUTA P. KELLY
GREGORY K. OYLER
LORI J. JONES
SAMUEL A. MITCHELL
LYNLEE C. BAKER
JANEL C. FRANK *

FRED C. SCRIBNER, JR. (1908-1994)
LEONARD W. HALL (1900-1979)

* NOT ADMITTED TO D.C. BAR

TAX ISSUES SUMMARY

April 30, 2009

***HIGHLIGHTS*:**

In General — Joint Budget Resolution Adopted This Week

Both the House and the Senate passed the conference report for the fiscal 2010 budget resolution yesterday, adopting a joint budget resolution that is seen as preserving the major priorities set forth in the Administration's budget plan. The budget resolution includes reconciliation instructions that would apply to healthcare reform, which would limit debate on the provision in the Senate and make passage of healthcare reform easier. It is expected that both houses of Congress will turn to the issue of healthcare reform now that the budget is passed. *See* Legislation.

I.R.C. § 817 — Variable Contract Holders Not Owners of Underlying Insurance RIC Shares Even If Such RICs Are Invested in Publicly-Available Mutual Funds

In PLR 200915006 (Apr. 10, 2009), the IRS ruled that investments in publicly-available mutual funds by several insurance-dedicated funds ("RICs") will not cause variable contract holders that allocate amounts to such RICs to be treated as the owners of the RIC shares for federal income tax purposes. This conclusion is opposite that of CCA 200840043 (June 10, 2008), which stated "[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* Company Issues.

LEGISLATION

1. In General — Joint Budget Resolution Adopted This Week

Both the House and the Senate passed the conference report for the fiscal 2010 budget resolution yesterday, adopting a joint budget resolution that is seen as preserving the major priorities set forth in the Administration's budget plan. The budget resolution would allow the tax-writing committees to raise $97 billion in revenue over five years, but would also allow current pay-go rules to be waived for: (1) extension of tax breaks for middle income earners and businesses (e.g., it extends the 10-percent bracket, the child tax credit, marriage penalty relief and education incentives, as well as the other 2001 and 2003 tax cuts extended in the Administration's budget for those families making under $250,000); (2) a three-year alternative minimum tax patch; and (3) the extension of the estate tax along the 2009 limits, indexed to inflation. It also provides for two years of extenders, subject to pay-go rules, as well as the enactment of various savings incentives. The House had conditioned the waiver of pay-go rules on the House passing a pay-go statute, but conceded that it would not condition the waiver on whether the Senate passed a similar statute.

Finally, the budget resolution also includes reconciliation instructions that would apply to healthcare reform, which would limit debate on the provision in the Senate (i.e., prevent the use of filibuster against healthcare legislation) and make passage of healthcare reform easier. The reconciliation instructions direct committees with jurisdiction over healthcare issues to report changes in laws to reduce the deficit by $1 billion. It is expected that both houses of Congress will turn to the issue of healthcare reform now that the budget is passed. Tentative schedules release by both the House and the Senate committees that would have jurisdiction over healthcare issues indicate that both houses want to have passed their respective versions of a healthcare reform by the August recess.

2. Tax Provisions Specific to Financial Institutions in American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 (Pub. L. No. 111-5), which was signed into law mid-February, contains a couple of tax provisions specific to financial institutions. The Act added a new I.R.C. § 265(b)(7), which exempts newly issued tax-exempt obligations from a financial institution's pro rata interest expense disallowance rules under I.R.C. § 265(b). This effectively reduces the interest expense disallowance attributable to these tax-exempt obligations from 100 percent to 20 percent. Also, there is new I.R.C. § 291(e), which provides that the tax-exempt obligations not taken into account for purposes of I.R.C. § 265(b) under this new provision are treated as having been acquired on August 7, 1986; I.R.C. § 291 generally disallows 20 percent of a financial institution's interest expense attributable to tax-exempt obligations acquired on or before August 7, 1986. It is important to note that the new provision applies only to I.R.C. § 265(b), and not to any disallowance under I.R.C. § 265(a)(2).

POLICYHOLDER ISSUES

1. I.R.C. § 817 — Variable Contract Holders Not Owners of Underlying Insurance RIC Shares Even If Such RICs Are Invested in Publicly-Available Mutual Funds

In PLR 200915006 (Apr. 10, 2009), the IRS ruled that investments in publicly-available mutual funds by several insurance-dedicated funds ("RICs") will not cause variable contract holders that allocate amounts to such RICs to be treated as the owners of the RIC shares for federal income tax purposes. The PLR reasoned that, even though the assets held by the RIC were available to the general public, the insurance RIC was not merely a conduit and the RIC shares were not available except through purchase of a variable contract. Note that the conclusion that the contract holders will not be treated as the owners of the underlying assets (i.e., the insurance RIC shares) even though the fund holds publicly available funds limits the conclusion made by CCA 200840043 (June 10, 2008), which stated "[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."

A taxpayer concern included in the facts of the PLR was whether the I.R.C. § 4982 excise tax will apply if the policyholders are considered owners of the shares. The ruling also includes as a "Representation" the following: "All the shares of each Existing Fund and the New Fund will be held directly or indirectly by segregated asset accounts of life insurance companies that are held in connection with variable contracts, as defined in Code § 817(d), and each Existing Fund and New Fund therefore will qualify for the exception from federal excise tax provided by Code § 4982(f), unless a variable contract holder is treated as a shareholder of the relevant fund pursuant to the investor control requirements of Revenue Ruling 81-225, 1981-2 C.B. 12, and Revenue Ruling 82-54, 1982-1 C.B. 11." Note that, although the ruling concludes that the contract holders will not be treated as the owners of the fund shares, it does not discuss I.R.C. § 4982 any further in the ruling.

COMPANY ISSUES

1. I.R.C. §§ 332 and 381(c)(22) — Liquidation of Insurance Subsidiary into a Non-Insurance Parent Does Not Transfer "Insurance Attributes"

In TAM 200914022 (Dec. 2, 2008), the IRS determined that the discounted unpaid losses of an insurance company subsidiary are not a tax attribute that can be transferred to its non-insurance parent company in a complete liquidation of the subsidiary. The insurance subsidiary had been part of the parent's consolidated return and had provided coverage to the parent and other subsidiaries for deductibles and self-insured retentions under the parent's casualty insurance programs (e.g., workers' compensation, auto liability, product liability and general liability). For valid business reasons the insurance subsidiary was liquidated and merged into the parent in a transaction that qualified as a

statutory merger and complete liquidation under I.R.C. § 332. The parent became responsible for all the liabilities and obligations of the insurance subsidiary. The IRS determined that the carryover of insurance items or attributes under I.R.C. § 381(c)(22) is limited to transfers in which the acquiring corporation is an insurance company. Thus, the IRS concluded that the discounted unpaid loss items of the subsidiary were unique to its status as an insurance company and not transferable to the non-insurance parent, and that the deferral that was available to the insurance subsidiary must be reversed by treating the ending discounted unpaid loss reserves as zero. Note that the TAM does not seem to consider whether the parent assuming the insurance subsidiary's liabilities might itself become an insurance company.

2. I.R.C. § 412(i) — Class Action Suit Has Some Claims Dismissed and Some Not

In *Hildebrandt v. Indianapolis Life Insurance Co.*, N.D. Tex., No. 3:08-CV-1815-B (Mar. 2, 2009 and Mar. 31, 2009), the U.S. District Court issued two rulings dismissing some of the claims in a class action complaint filed by a group of taxpayers against numerous defendants, including Bryan Cave (a law firm), American Express Tax & Business Services (insurance broker) and Indianapolis Life (the insurance company). The action arose from a dispute over the design, marketing and sale of an employee defined benefit plan know as the PENdulum Plan and related contracts issued by Indianapolis Life that were used to fund the plan. The plaintiffs claim that the plan was marketed as a qualified plan under I.R.C. § 412(i) when, in reality it was a tax avoidance scheme that the IRS identified as a listed transaction. The court refused to dismiss claims for negligent misrepresentation and nondisclosure, as well as for aiding and abetting and punitive damages, but did dismiss claims for breach of fiduciary duty and constructive fraud.

Likewise, in *Berry v. Indianapolis Life Insurance Co.*, Slip Copy, 2009 WL 804163, N.D. Tex. (Mar. 26, 2009), the court ruled against the motions for summary judgment of two other insurance companies (Pacific Life and Hartford) that the claims were without merit because transaction documents, wherein the insured plaintiffs expressly disclaim any reliance on the insurance companies for tax or legal advice, demonstrated that fact, as a matter of law. The court found that the plaintiffs could have justifiably relied on oral representations by insurance agents to the contrary, which the plaintiffs should be allowed to prove in court.

3. I.R.C. § 6015 — Tax Court Applies *Chevron* Analysis and Holds A Treasury Regulation Invalid

In both *Lantz v. Commissioner*, 132 T.C. No. 8 (Apr. 7, 2009) and *Mannella v. Commissioner*, 132 T.C. No. 10 (Apr. 13, 2009), the United States Tax Court applied a *Chevron* analysis and held Treas. Reg. § 1.6015-5(b)(1), which imposes a two-year limitations period for seeking equitable innocent spouse relief, to be an invalid interpretation of I.R.C. § 6015(f). I.R.C. § 6015(f) provides an equitable relief provision from joint and several liability on a joint return if relief is not available to the spouse under the statutory relief provisions in I.R.C. § 6015(b) or (c). Under the first step of the *Chevron* test,

the court determined that Congress had spoken directly to the issue — under I.R.C. § 6015(b) and (c), the statute specifically provides for a two-year limitations period for seeking relief and no such restriction is provided in I.R.C. § 6015(f), indicating that Congress did not want a two-year limitations period to apply to an individual seeking equitable relief. Although the Tax Court found that the regulation need not be given deference under *Chevron* because the statute was not ambiguous, it also considered the second step in a *Chevron* analysis and concluded that the regulation was not a permissible construction of the statute. It should be noted that there were several dissents to these holdings.

***IRS Circular 230 Disclosure*:**

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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
Scribner, Hall & Thompson, LLP, website: www.scribnerhall.com