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TAX ISSUES SUMMARY

July 31, 2009

HIGHLIGHTS:

I.R.C. §§ 812 and 817 — LMSB Issues Alert on Dividend Received Deduction for Life Insurance Company Separate Accounts Funds

The Industry Director for Financial Services, LMSB, recently provided an Issue Alert within the IRS LMSB to inform examiners that the dividends-received deduction (“DRD”) related to life insurance companies’ separate account assets remains a significant audit issue. The alert reminded examining agents to develop the facts, law, and arguments that support their position as outlined in the Financial Services Industry Director Directive (IDD) issued on April 22, 2008. *See* Company Issues.

I.R.C. § 1502 — Life-Nonlife Consolidated Return Priority Guidance Request Narrowed

Because the financial crisis may have increased the importance of new guidance on life-nonlife consolidated returns, Treasury asked the ACLI to narrow its request for priority guidance in that area to a few specific issues that can be resolved by regulation changes alone. ACLI’s request now focuses on three rules for changes: (1) the regulations should permit cross-subgroup carryback of life and capital losses; (2) the regulations should allow one subgroup’s capital losses to offset the other subgroup’s capital gains; and (3) the regulations should apply the general consolidated return pro rata loss absorption rules within a nonlife subgroup. *See* Company Issues.

LEGISLATION

1. In General — Both Houses of Congress Are Focused on Health Care

As Congress approaches the August recess, both the House and the Senate are focused on health care reform. Although the Democrats had managed to report a bill (H.R. 3200) only from two of the three House committees having jurisdiction, without any Republican support, it now looks like they may report out a significantly revised version of the bill from the Energy and Commerce Committee. This revised version is the result of agitation within the Democrats themselves, with the Blue Dog Democrats (who are generally fiscally conservative) questioning the contents of H.R. 3200 as not meeting the president's goal of substantially bringing down health care costs. Although this recently announced break-through with the Blue Dogs is being touted a real progress, it is still unlikely that the bill will be brought to the House floor before the August recess.

Regardless of what is the final form of the House health care reform bill, the revenue offsetting provisions are likely to be like those approved already by the House Ways and Means Committee. The cornerstone revenue offset approved by Ways and Means for the health care reform provisions is a surtax on the wealthy. The provision would begin with a 1 percent surtax on couples with a modified adjusted gross income of \$350,000 to \$500,000. Couples with a modified adjusted gross income of \$500,000 to \$1 million would be charged a surtax of 1.5 percent, and couples with a modified adjusted gross income of \$1 million or more would be charged a surtax of 5.4 percent. In 2013, if the desired savings from health care do not materialize, the tax will increase for each group; if the savings reach \$175 billion, the surtax on taxpayers making less than \$1 million will be eliminated. While House Democrats say the surtax will effect only 1.2 percent of households and 4.1 percent of small business owners, Republicans say it is the wrong approach and that the House should be focusing on tort reform, reforming health insurance regulations, small business tax incentives, and eliminating abuse and fraud in the Medicare and Medicaid system. Additionally, as revenue offsets, the bill would delay until December 31, 2019, the worldwide interest allocation provision of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, and also would codify the economic substance doctrine.

At the same time, although the Senate HELP Committee has reported out a health care reform bill (on a party line vote), a bi-partisan group of six members of the Senate Finance Committee have been working for the last couple of months to produce a bi-partisan, fully-paid-for health care reform bill. The leading revenue offset being considered seems to be an excise tax imposed on health insurers for health insurance plans valued at more than \$25,000. Reports are that the group is close to a final agreement and the bill may be presented to the Finance Committee (if not marked up) before the August recess. Senate Democratic leaders, however, have conceded that no health care reform bill will be brought to the Senate floor before the recess. Although the pre-ordained schedule of having both Houses of Congress vote on their bills before the August recess seems to have slipped, there still seems to be serious expectations that a health care reform bill can be enacted before October (which makes for a busy September).

In addition to health care reform, there also is the expectation that Congress will move on another energy bill, appropriations, and needed tax “extenders” as well as some estate tax solution. All this makes for a busy Fall, with many expecting Congress to stay in session until Christmas.

2. Statutory Pay-As-You-Go Act Passes in the House

On July 22, the House passed the Statutory Pay-As-You-Go Act of 2009 (H.R. 2920) with a 265-166 vote which would authorize the White House Office of Management and Budget, relying on the Congressional Budget Office cost projections, to cut mandatory spending programs if legislation enacted over the course of a calendar year adds to the deficit. House Democrats consider this pay-go bill a major achievement which will reassure constituents the markets, and the world that Congress is getting the fiscal house in order. The bill is expected to face opposition in the Senate, requiring the House to compromise and allow current policy extensions to be exempted from the pay-go rule. Opponents argue that the bill gives too much power to the executive branch, it should contain discretionary spending caps, and will not have any influence over the annual appropriations process. House Democrats disagree arguing that discretionary caps would set arbitrary spending limits and prevent necessary investments.

3. I.R.C. § 6607A — IRS Commissioner Suspends Collection of Some Tax Shelter Penalties as Lawmakers Plan Legislative Fix

IRS Commissioner, Douglas Shulman, has suspended collection of some penalties imposed for not disclosing listed transactions until September 30, 2009, specifically in cases where the annual tax benefit is less than \$100,000 for individuals or \$200,000 for other taxpayers. I.R.C. § 6707A applies where a taxpayer failed to disclose participation in a reportable or a listed transaction and imposes a strict liability penalty, whether or not there was reasonable cause or good faith reliance for such failure, and regardless of the amount of the tax benefit enjoyed by the taxpayer. This action was taken in anticipation of tax-writing committees taking up legislation that would bring I.R.C. § 6707A penalty amounts more in line with received tax benefits.

POLICYHOLDER ISSUES

1. I.R.C. § 163 — Taxpayer Is Not Allowed to Deduct Interest on Life Insurance Policy Loan

The Tax Court determined that, pursuant to I.R.C. § 163, taxpayers were not entitled to deduct interest paid on a life insurance policy loan because it was personal interest. In *Giannaris v. Commissioner*, T.C. Summ. Op. 2009-114, the taxpayer purchased a life insurance policy from Massachusetts Mutual Life Insurance Company and periodically borrowed against it, using the proceeds to supplement income. The taxpayer made no repayments on the loans or the interest that accrued.

Because the loan balance exceeded the value of the policy, the policy was terminated. The taxpayer reported a taxable gain resulting from termination of the policy and claimed a deduction for the total unpaid interest included in the loan balance, reporting it as home mortgage interest. However, the taxpayer paid no home mortgage interest that year because the loans underlying the interest were not secured by a residence, but by the life insurance policy.

2. IRC §§ 223(f) and 6331 — Levy May Attach to Taxpayer’s Health Savings Account

In CCA 200927019 (May 1, 2009), the IRS determined that a levy under I.R.C. § 6331 extends to a taxpayer’s interest in a health savings account (HSA). A distribution from an HSA to pay qualified medical expenses is excludable from gross income under I.R.C. § 223(f)(1), but a distribution to pay unqualified medical expenses is includable in gross income under I.R.C. § 223(f)(2) and subject to an additional 10 percent tax. A levy is not included as one of the three express exceptions to the 10 percent tax. IRS noted that the right to withdraw funds from an account is a property interest subject to levy and, therefore, the taxpayer’s interest in the HSA was subject to levy under I.R.C. § 6331. The taxpayer is liable for the additional 10 percent tax imposed by I.R.C. § 223(f)(4)(A) on the amount of the levy unless, at the time of the levy, the taxpayer had reached the age of 65 or is disabled.

COMPANY ISSUES

1. I.R.C. § 41 — Corporation May Rely on Test Found in 2001 Final Regulations to Determine Qualified Research for Credits

In *FedEx Corp. v. United States*, 103 A.F.T.R. 2d 2009-2722, (Jun. 6, 2009), the District Court granted the taxpayer’s motion for summary judgment on the legal standard for the “discovery” and “internal use software” tests under I.R.C. § 41(d). In 1996, FedEx began a research project to develop new and innovative technology for a computer business system. FedEx abandoned the project in 2001, and claimed qualified research expenses for the project in tax years ending 1997 through 2000.

The 2001 Final Regulations imposed a “discovery” test that required research be undertaken to “obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.” Treas. Reg. § 1.41-4(a)(3)(2001). The 2003 Final Regulations differed on the “discovery” test, requiring that research be “intended to eliminate certain uncertainties concerning the development or improvement of a business component.” Treas. Reg. § 4.41-4(a)(3)(2003). The 2001 Final Regulations state that “internal use software” may be eligible for qualified research credit (Treas. Reg. § 1.41-4(c)(6)(2001)), and the 2003 Final Regulations did not adopt a new test (Treas. Reg. § 4.41-4(c)(6)(2003)).

The Government argued that the taxpayer had to rely on the 2001 Final Regulations for both tests because they are closer in time to the tax years at issue. The Court disagreed, noting that the 2003 Final Regulations were meant to revise the “discovery” test to more correctly reflect Congressional intent. The 2003 Final Regulations govern the “discovery” test but, because there had been no revision, the 2001 Final Regulations govern the “internal use software” test.

2. I.R.C. § 162(a) — Payments to Welfare Benefits Fund Not Deductible

In *DeAngelis M.D. v. Commissioner*, 2009 W.L. 2168885 (2d Cir. July 21, 2009), the Second Circuit affirmed the Tax Court's decision for a group of consolidated cases, which held that S corporations and a partnership were not entitled to deduct payments related to a Severance Trust Executive Program Multiple Employer Supplemental Benefit Plan and Trust (STEP). The plan was promoted to wealthy professionals as a welfare benefits fund that was part of a 10-or-more employer plan described in I.R.C. § 419A(f)(6). Each of the consolidated cases involved a doctor and his spouse, and each doctor was the sole owner of an S corporation that was a partner in a partnership referred to as VRD/RTD. The S corporations paid amounts to VRD/RTD, which in turn contributed the amounts to the STEP program. The STEP then purchased and paid premiums on six life insurance policies, most of which were written with respect to one or both spouses of each couple and were payable to beneficiaries chosen by the insured upon the insured's death.

The taxpayers argued that I.R.C. § 162(a) allowed VRD/RTD to deduct the amounts contributed to the STEP because those amounts represented dismissal wages paid to a welfare or similar benefit plan. The Tax Court stated that while the plan "may have been cleverly designed to appear to be a welfare benefits fund and marketed as such, the facts of these cases establish that the plan was nothing more than a subterfuge, through which the participating doctors, through VRD/RTD, used surplus cash of the S corporations to purchase cash-laden whole life insurance policies primarily for the benefit of the participating doctors personally."

The VRD/RTD partnership could not deduct the amount it paid each year to STEP as contributions to the welfare benefits fund because the payments were distributions to the doctors personally and neither those payments nor VRD/RTD's ensuing contributions to STEP were ordinary and necessary business expenses under I.R.C. § 162(a).

3. I.R.C. §§ 812 and 817 — LMSB Issues Alert on Dividend Received Deduction for Life Insurance Company Separate Accounts Funds

Walter Harris, Industry Director for Financial Services, LMSB, provided an Issue Alert within the IRS LMSB to inform examiners that the dividends-received deduction ("DRD") related to life insurance companies' separate account assets remains a significant audit issue. The alert, dated July 15, 2009, encouraged examining agents to develop the facts, law, and arguments that support their position as outlined in the Financial Services Industry Director Directive (IDD) issued on April 22, 2008. The Alert indicates that LMSB recently identified a number of cases in the Field where taxpayers appear to have overstated the amount of the DRD taken in connection with the separate accounts funds, and states that this issue is present in virtually every life insurance case.

4. I.R.C. § 1502 — Life-Nonlife Consolidated Return Priority Guidance Request Narrowed

On May 29, 2009, ACLI requested the inclusion of various items in the 2009-2010 Guidance Priority List, including modification of the life-nonlife consolidated return regulations. Because the financial crisis may have increased the importance of new guidance on life-nonlife consolidated returns, Treasury asked ACLI to narrow its request for guidance to a few specific issues that can be resolved by regulation changes alone (and not need legislation). ACLI narrowed its request to focus on three rules and recommended changes that would bring the consolidated return treatment for affiliated groups more in line with the statute. The recommended changes are: (1) the regulations should permit cross-subgroup carryback of life and capital losses; (2) the regulations should allow one subgroup's capital losses to offset the other subgroup's capital gains; and (3) the regulations should apply the general consolidated return pro rata loss absorption rules within a nonlife subgroup. (Comment: If Treasury's request suggests that Treasury might be receptive to finally narrowing the limits in the regulations and that the issues suggested by ACLI might be addressed, such changes would be "huge" for the insurance industry.)

5. I.R.C. § 6621 — Parent and Subsidiaries Are Not Entitled to Interest Netting on Underpayments and Overpayments Incurred Separately for Years Before One Sub's LLC Conversion and the Other's DRE Election

In CCA 200929001 (Mar. 20, 2009), the IRS determined that a parent company and two of its subsidiaries are not considered the same taxpayer under I.R.C. § 6621(d) for tax years prior to one subsidiary's conversion to a LLC and other subsidiary's election to be treated as a disregarded entity ("DRE"). Therefore, the entities are not allowed interest netting on overpayments and underpayments incurred separately for years preceding the LLC conversion and DRE election. The parent company argued that the three entities were the same taxpayer because the LLC conversion and the DRE election were treated as liquidations to which I.R.C. § 332 applied. The IRS rejected this argument, stating that liquidations would not change the subsidiaries' liability status regarding the prior tax periods according to state law. The two subsidiaries did not join the filing of the parent's consolidated income tax return for the periods at issue, even though they were owned by the parent.

6. FASB Will Not Use Risk Margins for Measurement of Insurance Liabilities

On July 21, 2009, The Financial Accounting Standards Board ("FASB") continued deliberations regarding accounting for insurance contracts, and tentatively said that it would not vote to include risk margins in the accounting treatment for measurement of an insurance liability. FASB was concerned that risk margins added complexity, as well as a cushion or conservatism to the measurement of the insurance liability. FASB said including the risk margin is not necessary since the boards are already using an expected value calculation that incorporates most of the information needed.

FASB also said it would not consider an insurance liability measurement approach based on an updated IAS 37, Provisions, Contingent Liabilities and Contingent Assets. Rather, they voted to keep the current fulfillment value approach which has only a composite margin, not a risk margin. At the July 21, 2009 meeting, FASB tentatively decided that the time value of money should be included in the insurance liability measurements, and whatever discount rate is used to determine the time value of money should be updated each reporting period. FASB did not determine the rate to be used.

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