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TAX ISSUES SUMMARY

August 31, 2009

HIGHLIGHT:

***En Banc* First Circuit Holds Tax Accrual Work Papers are Not Privileged**

In *U.S. v. Textron, Inc.*, No. 07-2631 (1st Cir. Aug. 13, 2009), the First Circuit vacated the District Court's determination that tax accrual work papers were 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 — During Recess, the Healthcare Reform Debate Is Carried on Outside the Beltway

While Congress has been on its August recess, the healthcare debate not only continued, but seemed to become more contentious. While some believe the questions and doubt expressed by the public signals delay, if not the end, of healthcare reform, others say that those leading the healthcare reform activities will return invigorated and determined to pass a bill that President Obama can sign. In either case, most of September is likely to be dedicated to healthcare, compressing the time in which other tax matters (e.g., a fix for the estate tax or consideration of extender provisions) can be taken up.

2. Legislation to End Tax Deduction for Foreign Reinsurers Reintroduced

Rep. Richard Neal (D-Mass.) again introduced legislation that would disallow the deduction for excess non-taxed premiums paid to affiliated foreign reinsurers with respect to U.S. risks. The bill would allow taxpayers to opt out of the disallowance of a deduction by electing to treat affiliate reinsurance income, rather than all income, as subject to U.S. tax. This is a change from the bill that was introduced by Neal in the last Congress which is intended to close the loophole perceived to provide foreign-controlled insurers a significant tax advantage over their domestic competitors.

POLICYHOLDER ISSUES

1. I.R.C. § 7702 — ACLI Requests Postponement of Rev. Rul. 2009-13

ACLI has asked the IRS to suspend the August 31 effective date for Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, to allow enough time for the IRS to consider the issues raised by ACLI's July 31 comment letter. ACLI expressed concern that Rev. Rul. 2009-13's conclusion that the amount of taxable income to be recognized by a policyholder upon a life insurance policy transfer must be increased by the imputed cost-of-insurance charges lacks legal authority.

In Rev. Rul. 2009-13, the IRS issued guidance for three situations on the amount and character of an individual's income recognized on the surrender or sale of the individual's life insurance contracts. In Situation 2, the individual owner sold the life insurance contract to an unrelated individual. The IRS ruled that, because such a sale is not covered by I.R.C. § 72, the individual must recognize the excess of the amount realized on the sale over the individual's adjusted basis of the life insurance contract. Although the IRS concluded that the sale of the contract was the sale of property which could give rise to capital gain, it also concluded that the substitute-for-ordinary-income doctrine applied, causing the amount recognized as income to be ordinary to the extent it would have been ordinary income if the contract had been surrendered. The individual must recognize as ordinary income the cash surrender value of the contract, less aggregate premiums paid. The remaining income recognized on the sale of the contract is long-term capital gain. Thus, even though a portion is characterized as capital gain, the owner must recognize more income if the contract is sold as opposed to surrendered.

ACLI's concern is that Situation 2 may be contrary to tax policy and established law. The ruling does not fully consider the issues surrounding the character of income realized on a sale of an in-force life insurance contract, and ACLI does not believe that the IRS applied the substitution-of-income doctrine correctly. ACLI suggests the IRS add more factual situations to clarify that the ruling applies to sales of in-force life insurance contracts by owner-insureds to unrelated purchasers who would not experience an economic loss if the insured dies.

2. I.R.C. § 419 — IRS Provides Guidance on Welfare Benefit Plans and Funds

In CCA 200931049 (Jan. 22, 2009), IRS offered a background document to I.R.C. § 419(e), describing various arrangements and rules associated with welfare benefit plans and funds. IRS's position on related topics is also outlined.

COMPANY ISSUES

1. I.R.C. § 385 — IRS Determines Securities Are Debt for Tax Purposes

In CCA 20093249 (Mar. 10, 2009), the IRS agreed with the characterization of trust preferred securities (TPS) as debt for tax purposes even though TPS have equity-like characteristics and they are treated as equity for regulatory purposes. The IRS used the eight factors identified in Notice 94-47, 1994-1 C.B. 357, to determine how interest in a corporation is to be treated. The first factor in Notice 94-47 is whether there is an unconditional promise on the part of the issuer to pay a sum certain on

demand, or at a fixed maturity date in the reasonably foreseeable future. A TPS promise to pay a sum certain on a definite maturity date in the distant future suggests equity because it exposes the investment to greater risk of an issuer's business and creates uncertainty regarding timing and certainty of the repayment. However, the IRS noted that the Issuer in question has operated a substantial operating business for an extended period using long-lived assets, and consistently paid dividends on the common stock. Given the terms of the instruments and expectations of the marketplace, the IRS did not think that the long maturity date in the case at issue was the decisive factor, and weighed the other factors to determine that the TPS should be treated as debt for tax purposes.

2. I.R.C. § 842(b) — IRS Releases Domestic Asset /Liability Percentages and Investment Yields for Foreign Life Insurance Companies

In Rev. Proc. 2009-34, 2009-34 I.R.B. 258, the IRS released the domestic asset/liability percentages and domestic investment yields needed by foreign life insurance companies and foreign property and liability insurance companies to compute their minimum effectively connected net investment income under I.R.C. § 842(b). The guidance provides instructions for computing the liabilities of foreign insurance companies for the estimated tax and installment payments of estimated tax for those tax years. Rev. Proc. 2009-34 is effective for taxable years beginning after Dec. 31, 2007.

3. *En Banc* First Circuit Holds that Tax Accrual Work Papers are Not Privileged

In *U.S. v. Textron, Inc.*, No. 07-2631 (1st Cir. Aug. 13, 2009), the First Circuit vacated the District Court's determination that tax accrual work papers were protected by the work product privilege and that the business purpose of the documents did not defeat the privilege. The 3-2 majority held that the work product privilege is aimed at protecting work in litigation, not in preparing financial statements, and that the IRS access serves the legitimate and important function of detecting and disallowing abusive tax shelters. The work papers at issue were required by statutory and audit requirements and the work product privilege does not apply.

In January, the First Circuit held that the work papers were protected by the work product privilege even if they are required by financial reporting rules, and it was remanded to the District Court to determine if Textron waived the privilege by disclosing documents to its outside auditor. The District Court determined that the documents were prepared in anticipation of litigation and were therefore improper for the government to access. The *en banc* majority acknowledged that "how far work product protection extends turns on a balancing of policy concerns rather than application of abstract logic." The Court had not previously ruled on how to treat a document that is not in any way prepared for litigation but "relates to a subject that might or might not occasion litigation." The Court concluded that the work papers "were independently required by statutory and audit requirements and that the work product privilege does not apply." The minority said that the majority was abandoning the "because of" test relied on in *Maine v. U.S. Dep't of the Interior*, 298 F.3d 60, 68 (1st Cir. 2002), and replacing it with a watered down version that "brushes aside the actual text of Rule 26(b)(3)."

Some practitioners believe that *Textron* could go all the way to the Supreme Court because there are significant non-tax ramifications involved. Corporate lawyers worry that the Court's narrow reading of the work product privilege will make it difficult for all corporate in-house lawyers to function, tending to discourage them from putting the financial liability into the books because the background documents are potentially discoverable.

4. ACLI Makes an Additional Submission on Life Insurance Securitizations and Funding Transactions

As the IRS and Treasury further consider the tax treatment of life insurance securitizations and funding transactions, the ACLI has asked them to take into account three basic points. First, reinsurers in life insurance reserve funding transactions must be adequately capitalized to support the issuance of debt because the purchasers of the debt generally are financial institutions or their customers who are interested in purchasing only highly-rated debt. Also, the state insurance regulators for both the reinsurer and the ceding company demand adequate capitalization. Second, the debt instruments issued in these transactions qualify for debt for tax purposes under typical debt-equity analysis; they are issued with a fixed maturity date in the future at which the creditor can unconditionally require payment of a particular sum. And, third, debt instruments issued in life insurance reserve funding transactions are materially different from instruments issued in connection with catastrophe bonds because the former do not transfer any insurance risk to the creditors.

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For comments or questions, or if you would like to receive the Tax Issues Summary via electronic mail, please contact Jacquelyn M. Pearo at (202) 434-9177 or jpearo@scribnerhall.com Scribner, Hall & Thompson, LLP, website: www.scribnerhall.com