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
JANEL C. FRANK *
DAVE RIFKIN

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

* NOT ADMITTED IN D.C.

TAX ISSUES SUMMARY

September 30, 2009

***HIGHLIGHTS*:**

I.R.C. § 72 — Contracts with No Cash Value or Death Benefits During a Deferral Period Qualify as Annuities

In PLR 200939018 (June 18, 2009), the IRS ruled that contracts that provide no cash value, death benefits or annuitization rights during a deferral period, which ends before an annuity starting date, qualify as annuities for purposes of I.R.C. § 72. The ruling concludes that the contracts do not make periodic payments of interest but provide for periodic payments that are designed to liquidate a fund. The IRS found that neither the lack of accessible cash value during the deferral period, nor the requirement that the annuitant survive the deferral period to receive benefits is inappropriate or inconsistent with the contracts being characterized as annuities. *See* Policyholder Issues.

I.R.C. §§ 404 and 832 — Future Retiree Medical Benefits Not Deductible as LAE for Nonlife Insurance Company

In TAM 200939019 (June 10, 2009), the IRS concluded that a property and casualty insurance company is prohibited from taking a current deduction for future retiree medical benefits based on the timing rules set out in I.R.C. § 404(a)(5), even though such amounts are included as part of the company's loss adjustment expenses (LAE) for that year. *See* Company Issues.

LEGISLATION

1. In General — Health Care Continues to Occupy the Spotlight for Tax-Writing Committees

Congress returned from its August recess, which included numerous town hall meetings with animated debates on health care reform, with apparently little movement having been made toward any

consensus on health care reform legislation. Then, on September 16th, Senate Finance Committee Chairman Max Baucus (D-Mont.) unveiled his health care reform proposal, which is relatively more modest than the bills already reported by other Senate and House committees and would use health-related revenue offsets and new fees on the health industry to pay for a portion of the reform. There would be a nondeductible 35 percent excise tax on "Cadillac" health insurance plans (i.e., those with an actuarial value in excess of $8,000 for individuals and $21,000 for families), a per-year limit on employer contributions to tax-free flexible spending accounts in cafeteria plans, and non-allowance of HSA reimbursements for over-the-counter medicines. Taxpayers falling between certain percentages of the federal poverty line would be eligible for advanceable, refundable tax credits and small-business employers would have access to a tax credit of up to 35 percent of their contribution to health care coverage. The proposal would create a safe harbor from nondiscrimination rules for cafeteria plans sponsored by eligible, participating, and contributing small employers with an average of 100 or fewer employees, but all employees not specifically excluded would have to be eligible to participate in the plan and to select any benefit provided. Other tax offsets include: eliminating the Medicare Part D deduction, increasing the penalty for nonqualified distributions from HSAs, requiring corporate information reporting, imposing new requirements on nonprofit hospitals and businesses, and allowing FSAs to be used on long-term care. Unlike the other bills reported by the House and Senate committees, Baucus' proposal has been estimated as being revenue neutral and is the only one judged by the Congressional Budget Office as having provisions that would actually curb health care costs over time. Despite achieving these sought-after goals, the proposal has been criticized by both Republicans and Democrats (does that meet the goal of bipartisanship?). The proposal has been the subject of Senate Finance Committee markup since last Tuesday.

2. JCT Publishes Pamphlets on Administration's Budget Revenue Proposal as Tax-Writing Committees May Start to Consider Expiring Provisions

During the first half of September, the Joint Committee on Taxation staff (JCT) published two more reports describing revenue provisions contained in the Administration's 2010 budget proposal, covering business tax provisions and cross-border income and investment taxation. Of particular interest to life insurance companies, are the discussions of the proposals that would modify rules applying to sales of life insurance contracts, modify the dividends-received deduction related to life insurance company separate accounts, and expand the pro rate interest expense disallowance for company-owned life insurance. Although, generally, the JCT pamphlet descriptions discussed the proposal and the espoused underlying tax policy, with respect to the separate account dividends-received deduction, the pamphlet argues for alternative proposals. The Administration offered these revenue proposals as possible funding for health care reform. While Congress seems more intent on funding health care reform through general rate increases on high-income taxpayers or tax provisions related in some way to health care, the search for revenue raisers will become more intense as Congress turns to the extension of expiring provisions.

Although serious consideration of expiring provisions will wait for resolution of the legislative efforts on health care reform, Congress already has begun to look at expiring tax provisions. Authorizations for funding of the Highway Trust Fund and the Airport and Airways Trust Fund are set to expire on September 30; there has been a short-term extension to allow more time to draft a new authorization bill. The first-time home buyer credit applies only to home purchases that have closed by

November 30, and there are proposals not only to extend the credit, but to increase the amount and make it more accessible to active-duty military personnel. Then, there is no expectation that Congress will allow the estate tax to expire for 2010; proposals being considered range from extending the 2009 provisions for one year (at least) to a permanent modifcation on the tax provisions in line with those effective for 2009. Finally, the rather long list of regular "extender provisions" is expected to surface again this year. Because the cost of extending all these expiring provisions will be substantial, the search for revenue offsets can be expected to be broad given the increasing concerns for deficit spending.

3. Legislators Act on Taxation of Nonadmitted Insurance and Reinsurance

The House recently passed H.R. 2571 aimed at simplifying regulation of nonadmitted insurers and reinsurers by establishing a national standard for regulation and collection premium taxes. Currently, states have varying formulas for premiums. Under the bill, to avoid double taxation, the policyholder's home state, not the state where the nonadmitted insurer or reinsurer is located, would have authority over the collection and allocation of taxes on premiums. A companion bill in the Senate is S. 1363. The Senate Banking Committee said there is a possibility that this will be included in the health care reform package since it is fairly non-controversial on its own.

POLICYHOLDER ISSUES

1. I.R.C. §§ 61 and 817(h) — Insurance Contractholders Not Treated as Owners of Assets Underlying Variable Contracts

In PLR 200938006 (June 17, 2009), the IRS concluded that the fact that a Fund, used as an investment option for variable contracts invested, will invest not only in insurance dedicated funds, but also in public mutual funds, would not cause the variable contractholders to be treated as the owners of the Fund shares for federal income tax purposes. Apart from the contractholder's ability to allocate premiums and transfer amounts to and from the Fund, all investment decisions concerning the Fund are made by the investment advisor in its sole and absolute discretion. Likewise the Fund will comply with the diversification requirement of I.R.C. § 817(h) and will treat each investment in a public mutual fund as a single investment. Accordingly, because the variable contractholder had no control over the asset investment decisions for the funds underlying the contract, the contractholder is not viewed as the owner of the assets and is not taxed on any income and gains attributable to those assets.

Similarly, in PLR 200938018 (June 29, 2009), the IRS concluded that the contractholder of the variable contract will not be treated as the owner of the fund assets underlying the contract even though some of the funds available for the contract will follow a "target date" investment strategy and automatically change the asset allocation model for a holder's contract funds from more aggressive to more conservative as the holder's anticipated retirement date approaches.

2. I.R.C. § 72 — Contracts with No Cash Value or Death Benefits During a Deferral Period Qualify as Annuities

In PLR 200939018 (June 18, 2009), the IRS ruled that contracts that provide no cash value, death benefits or annuitization rights during a deferral period, which ends before an annuity starting date, qualify as annuities for purposes of I.R.C. § 72. The ruling concludes that the contracts do not make periodic payments of interest but provide for periodic payments that are designed to liquidate a fund. The IRS found that neither the lack of accessible cash value during the deferral period nor the requirement that the annuitant survive the deferral period to receive benefits is inappropriate or inconsistent with the contracts being characterized as annuities.

In analyzing the contracts, the IRS first noted and recognized that historically, and in particular during the first half of the 20th century, it was common for insurance companies to issue deferred annuity contracts that did not provide cash value or death benefits during the deferral period. It also found that there was nothing in I.R.C. § 72 or Treas. Reg. § 1.72-2 that prohibited this practice. Thus, the IRS concluded that the proposed contracts could be considered annuity contracts "in accordance with the customary practice of life insurance companies," as prescribed in Treas. Reg. § 1.72-2(a)(1). Next the IRS considered whether payments under the contracts would be periodic payments of an annuity (i.e., amounts received as an annuity under I.R.C. § 72), or periodic payments of interest (which do not qualify as amounts received as an annuity under I.R.C. § 72). Key to this determination was the IRS' finding that the contracts provided permanent annuity purchase rate guarantees, and that the scheduled periodic payments provided by the contracts would result ultimately in liquidation of the underlying funds. Accordingly, the IRS concluded that the contracts would constitute annuity contracts for purposes of I.R.C. § 72.

3. I.R.C. § 104 — Tort-Type Rights Test Removed in Proposed Regulations on Exclusion of Damages from Sickness and Physical Injuries

The IRS issued proposed regulations (REG-127270-06) covering the exclusion from gross income amounts received as a result of personal physical injuries or physical sickness, and amounts received for emotional distress attributable to a physical injury or physical sickness. The emotional distress damages cannot exceed the amount paid for the corresponding medical care, and punitive damages may not be excluded from income. The rules reflect amendments to I.R.C. § 104(a)(2) by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188.

The proposed regulations eliminate the requirement that personal injuries or sickness be based on tort-type rights because the test has become unnecessary given legislative and judicial developments. Thus, as stated in the background explanation to the proposed regulations, "damages for physical injuries may qualify for the . . . exclusion even though the injury giving rise to the damages is not defined as a tort." The proposed regulations would apply to damages paid under a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995 and received after the date the final regulations are issued.

4. I.R.C. § 402 — Group Annuity Purchased with Terminated Plan Assets Is Not a Qualified Plan; Demutualization Proceeds Are Not Plan Assets

In PLR 200938030 (June 26, 2009), the IRS ruled that a group annuity contract purchased with assets from a terminated retirement plan is not a qualified retirement plan. As a result, when the company that issued the group annuity contract later converted from a mutual company to a stock company, the demutualization proceeds from the conversion are not plan assets because the terminated plan was not in existence at the time of the demutualization.

5. I.R.C. § 402A — Rules for Transferring Eligible Rollover Distributions from Qualified Plans to Roth IRAs

IRS issued Notice 2009-75, 2009-39 I.R.B. 436, to clarify the federal tax consequences of transferring rollover distributions from qualified I.R.C. §§ 401(a), 403, and 457(b) plans to Roth IRAs. The amount that would be included in gross income were it not part of a qualified rollover contribution should be included in the recipient's gross income for the year of the distribution. The amount included in gross income would be equal to the amount rolled over, minus the amount of any after-tax contributions that are included in the amount rolled over. The special rules pursuant to I.R.C. § 402(e)(4) would not apply. A rollover distribution made before January 1, 2010, from an eligible employer plan may not be rolled over unless, for the year of the distribution, the modified adjusted gross income does not exceed $100,000, or if the recipient is married and filed a joint return with his or her spouse. Notice 2009-75 also set distribution rules for rollovers from a designated Roth account to a Roth IRA. The amount rolled over would not have to be included in the recipient's gross income, and no restrictions based on modified adjusted gross income limitations and joint filing requirements would apply.

6. Treasury Department Official Would Encourage Automatic Annuitization Options for Retirement Plans

At the September 11 Guaranteeing Savings to Last a Lifetime Conference sponsored by ACLI, AARP, the Americans Benefits Council, the U.S. Chamber of Commerce, and the Women's Institute for a Secure Retirement, J. Mark Iwry (senior advisor to Treasury Secretary Timothy Geithner) indicated that policymakers are considering how to encourage employers to design retirement plans that provide greater retirement security than defined contribution plans offer now by expanding qualification requirements to include automatic annuitization rules. Safe harbor regulations, cost and portability of annuities, and jurisdictional issues are being discussed. Also at this conference, the Department of Labor announced that it is preparing to issue a request for information from the insurance industry and retirement plan community about new annuitization products, education of participants about the importance of options, and mechanisms for converting lump sums into lifetime income payments. *Daily Tax Report* G-5 (BNA Sept. 14, 2009).

COMPANY ISSUES

1. I.R.C. § 61 — Benefit Valuation Rates Issued for Employer-Provided Aircraft

In Rev. Rul. 2009-28, 2009-39 I.R.B. 391, the IRS announced the cents-per-mile rates and terminal charges in effect for the second half of 2009, to be used in valuing noncommercial flights on employer-provided aircraft and taxing the value as a fringe benefit. The standard industry fare level mileage rates for the second half of 2009 are $0.2501 per mile up to 500 miles; $0.1907 per mile from 501 to 1,500 miles; and $0.1833 per mile for over 1,500 miles. The terminal charge for the period is $45.71.

2. I.R.C. § 264 — Disallowed Interest Does Not Reduce Earnings and Profits when the Death Benefit Is Received Under a Life Insurance Contract

In Rev. Rul. 2009-25, 2009-38 I.R.B. 365, the IRS discusses when policy loan interest payments disallowed as a deduction under I.R.C. § 264(a)(4) should be taken into account for a corporation's earnings and profits. In the facts provided, X, a subchapter C corporation, purchased a paid-up life insurance contract with a $500 death benefit from A, an unrelated individual for $100. In order to fund the transaction, X borrowed $100 at 7% interest and paid $7 of interest at the end of Year 1 and Year 2. The insured died at the beginning of Year 3 and the death benefit was paid to X. I.R.C. § 264(a)(4) disallows a tax deduction for interest paid or accrued on indebtedness related to the purchase of a life insurance contract.

As a basic premise, the ruling recognizes that earnings and profits are a measure of a corporation's ability to pay dividends. Consequently, deductions and losses not allowed for tax purposes may be taken into account in computing earnings and profits because they reduce the amount of a corporation's assets. The ruling concludes that interest payment deductions disallowed under I.R.C. § 264(a)(4) during the life of the contract reduced corporate assets in each year the deduction was disallowed and, therefore, should reduce earnings and profits in each of those respective years. Because the interest payments were taken into account as a reduction to earnings and profits when the deduction was disallowed, the ruling also concludes that the disallowed interest payments should not be taken into account again as a reduction to the death benefit proceeds includible in earnings and profits when the death benefit is paid. Although the ruling recognized that, under I.R.C. § 101(a)(2), X would be required to include $386 of the death benefit proceeds in gross income ($500, less the $100 consideration paid, less $14 of other payments (interest)), it would be required to increase earnings and profits by $400 in the year the death benefit was paid.

3. I.R.C. §§ 404 and 832 — Future Retiree Medical Benefits Not Deductible as LAE for Nonlife Insurance Company

In TAM 200939019 (June 10, 2009), the IRS concluded that a property and casualty insurance company is prohibited from taking a current deduction for future retiree medical benefits based on the timing rules set out in I.R.C. § 404(a)(5), even though such amounts are included as part of the company's loss adjustment expenses (LAE) for that year.

The taxpayer, a property and casualty insurance company, provided future retiree medical benefits to its claims personnel, but no amounts related to these benefits were currently contributed to any welfare benefit plan. The taxpayer included the discounted amount of the future retiree medical benefits in its calculation of unpaid LAE, which resulted in an increased loss deduction. The IRS acknowledged that the taxpayer may be required to account for the retiree medical benefits according to NAIC accounting standards as referenced in I.R.C. § 846. However, the IRS rejected the taxpayer's arguments that the retiree medical benefits included in LAE were not subject to I.R.C. § 404(a)(5): (1) because LAE are included specifically in "unpaid losses" under I.R.C. § 846(f)(2); and (2) because LAE is an offset to gross income rather than a deduction. The IRS referred to the legislative history of a 1986 clarifying amendment to I.R.C. § 404 setting forth the Congressional intent that the deduction-timing rules for deferred compensation arrangements apply to any plan or method of deferring compensation regardless of the section under which the amounts might otherwise be deductible. Accordingly, because the retiree medical benefits are deferred benefit arrangements, they are deferred compensation the deduction for which is governed by the timing rules of I.R.C. § 404.

Note that the conclusion of TAM 200939019 is consistent with TAM 9723005 (Feb. 6, 1997) and NSAR Vaughn #20380 (May 9, 2002).

4. I.R.C. § 831 — When a Reinsurance Arrangement Is Sufficient for the Assuming Company to Qualify as an Insurance Company

In Rev. Rul. 2009-26, 2009-38 I.R.B. 366, the IRS presented two situations to illustrate the application of insurance principles to a reinsurance arrangement to determine if there is sufficient risk distribution present for the assuming company to qualify as an insurance company. Under I.R.C. § 816(a), "insurance company" means "any company more than half the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies." In order for an arrangement to constitute insurance for federal income tax purposes, risk shifting and risk distribution must be present.

In Situation 1, the direct writer entered into a 90% quota share reinsurance contract with the reinsurer that covered 10,000 insurance policies issued in the commercial multiple peril line of business. This was the reinsurer's only business during the year. The ruling found that the policies issued by the direct writer involved insurance risks, transferred those risks from 10,000 unrelated policyholders to the direct writer, distributed those risks (in that a loss by one policyholder was not borne in substantial part by that policyholder's premiums), and were insurance in the commonly accepted sense. The ruling also found that the reinsurance contract between the direct writer and the reinsurer likewise transferred the risks to reinsurer and constituted reinsurance in the commonly accepted sense. With respect to risk distribution, the ruling concluded that the reinsurance contract did nothing to disturb the distribution of the risks of the 10,000 policyholders that had been achieved by their policies with the direct writer. Thus, the reinsurer qualified as an insurance company for tax purposes.

In Situation 2, the facts were the same, except that the reinsurance contract with the direct writer covered the risks of only one policyholder (X, unrelated to the reinsurer), and reinsurer also entered into reinsurance contracts with other insurance companies to assume additional policies in the same line of business. In this situation, although the risks of the single policyholder (X) assumed from the direct

writer may not have been "distributed" when viewed in isolation, risk distribution was achieved by the reinsurer's assumption of similar risks of unrelated policyholders from other insurance companies, so that the risks of each original policyholder (including X) were distributed so that a loss by one policyholder was not borne in substantial part by that policyholder's premiums. Therefore, the ruling concluded, the reinsurer was treated as an insurance company under I.R.C. § 831(c) in Situation 2 as well.

5. I.R.C. § 882 — Effectively Connected Income Exists Where Foreign Corporation Used U.S. Agent to Originate Loans

A foreign corporation has income that is effectively connected with the conduct of a trade or business within the U.S. because the foreign corporation originated loans in the U.S. through an agent, according to IRS "generic legal advice" (*Highlights & Documents* 5853 (Tax Analysts Sept. 23, 2009) (no IRS citation)). The foreign corporation out-sourced its U.S. loan origination activities to an agent, a U.S. corporation, which performed all loan origination activities except final approval and signing of the loan documents. IRS concluded that the foreign corporation did not qualify for any of the safe harbors under I.R.C. § 864(b) and was engaged in trade or business in the U.S. under I.R.C. § 882(a)(1). The interest income received on the loans that originated in the U.S. was effectively connected because the foreign corporation was engaged in a banking business and the interest income is attributable to a U.S. office.

6. ACLI Writes Letter About Apparent Breakdown in IRS Guidance Process

In a letter dated September 1, 2009 (2009 TNT 168-12), the American Council of Life Insurers (ACLI) expressed its concern for two projects on the Treasury and IRS Priority Guidance Plan — guidance on AG 43 and the dividends-received deduction for separate account assets. ACLI stated "[t]he guidance process should set policy and lead the examination process," not "waste[ ] the government's resources, and leave[ ] taxpayers to pay their taxes and prepare financial statements without the certainty necessary to efficiently conduct business."

7. Seventh Circuit Upholds Preliminary Injunction in Credit Default Swap Case

In *Hoosier Energy Rural Electric Cooperative Inc. v. John Hancock Life Ins. Co.*, No. 08-4030 (7th Cir. Sept. 17, 2009), the district court granted the preliminary injunction preventing John Hancock from taking action that would have forced Hoosier to make payments because of a technical fault in a credit default swap, potentially driving Hoosier into bankruptcy (i.e., causing irreparable injury). Hoosier Energy Rural Electric Cooperative and John Hancock Life Insurance Co. entered into a leveraged lease where John Hancock paid Hoosier for a lease and interest in their company's plant, while Hoosier agreed to lease back the plant, making periodic payments. Hoosier also provided additional security in the form of a surety bond and credit default swap, under which Ambac Assurance Corp. agreed to pay John Hancock if certain events occured. As a contingency, if Ambac's credit rating fell below a certain point, Hoosier had 60 days to find a replacement that satisfied the contract. Ambac's credit rating did fall, and John Hancock allowed Hoosier 120 days to find a replacement before calling on Ambac to perform. If Ambac paid, it would demand that Hoosier cover the outlay, which would drive

Hoosier into bankruptcy. The court stated that interlocutory relief was justified because this transaction is an abusive tax shelter and, under New York law, temporary commercial impracticability permitted Hoosier to defer coming up with another swap partner until the economy improved.

The Seventh Circuit recognized the fact "that John Hancock may have set out to take larger deductions than the law allows does not affect Hoosier Energy's contractual duties." But, the court noted that it was unclear whether Hoosier had a duty to replace Ambac or an option to do so. Also uncertain was whether the 2008 credit crunch was foreseeable or whether Ambac could have been replaced by offering a better security. These uncertainties, said the Seventh Circuit, support the district court's conclusion that Hoosier may succeed on the merits of the case. The court cautioned that what was impossible in 2008, may be possible in 2009, and the longer this continues, the more likely the "balance of equities tilts in favor of John Hancock."

***IRS Circular 230 Disclosure*:**

This newsletter is provided solely for informational purposes and is not intended to furnish legal advice with respect to the reader's particular factual circumstances. In accordance with § 10.35 of IRS Circular 230 requirements, you are advised that any discussion of tax issues in this newsletter is not intended or written to be used, and cannot be used, to avoid penalties imposed under the Internal Revenue Code or to promote, market or recommend to another party any transaction or matter addressed herein. The persuasiveness of this newsletter's discussion with regard to the tax issues in question and a taxpayer's good faith reliance on the newsletter will be determined under applicable provisions of the law and regulations (§ 10.35(f)).

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