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TAX ISSUES SUMMARY

November 30, 2009

***HIGHLIGHTS*:**

I.R.C. § 172(b) and 810(b) — Guidance on New NOL and Operations Loss Carryback Provisions

On November 20th, IRS issued Rev. Proc. 2009-52, 2009-49 I.R.B. __ regarding the recently enacted loss carryback provision in section 13 of the Worker, Homeownership, and Business Assistance Act of 2009 (*see* Legislation, # 1), which allows taxpayers to elect to carry back an applicable NOL (including a consolidated NOL) or an applicable loss from operations up to 5 years. The election applies to an NOL or operations loss from a taxable year ending after December 31, 2007, and beginning before January 1, 2010. *See* Company Issues.

Treasury and the IRS Release the 2009-2010 Priority Guidance Plan

Some five months into the new "plan year," Treasury and the IRS has released its 2009-2010 Priority Guidance Plan. Of the ten items specifically listed for "Insurance Companies and Products," only three items are new and not carried over from last year. *See* Company Issues.

LEGISLATION

1. In General — Work on Health Care Reform Continues; Home Buyer Credit and NOL Carryback Expanded

In the midst of the continued scramble by Congressional Democrats to pass some health care reform legislation (with the House Democrats passing a bill primarily funded by a surtax on the "rich," and the Senate Democrats just managing to win a vote to bring their health care reform bill to the floor

sometime after Thanksgiving), both houses of Congress passed The Worker, Homeownership, and Business Act (H.R. 3548), which was signed into law by President Obama on November 6. In addition to providing at least 14 more weeks of unemployment insurance benefits, the Act extends and expands home buyer tax credits and net operating loss (NOL) carryback rules. More specifically, the law extends the $8,000 first-time home buyer tax credit of the American Recovery and Reinvestment Act, Pub. L. No. 111-5, into 2010 and also allows existing homeowners to take a $6,500 tax credit if they purchase a new primary residence. Income caps for eligibility have been raised to $125,000 for individuals and $225,000 for couples, and military personnel serving overseas will have an additional year to take the home buyer tax credits. The law also expands the NOL carryback provision, allowing all companies (not just small businesses) with a loss in either 2008 or 2009 to claim refunds of taxes paid within the prior five years; the same provision applies for an operations loss of a life insurance company. Businesses that received funding from the Troubled Asset Relief Program are not eligible. The cost of these provisions was offset by a six year delay of the implementation of the worldwide interest allocation rule, extension of the .2 percent Federal Unemployment Tax Act surtax, and increased penalties for failure to file S corporation and partnership tax returns.

2. Lawmakers Propose Modifications of Tax Shelter Penalties

A bipartisan group of lawmakers in the House and Senate introduced the Small Business Penalty Relief Act of 2009 (H.R. 4068, S. 2771) which would soften the reportable transaction failure-to-disclose penalties assessed after December 31, 2006 under I.R.C. § 6707A. The legislation was prompted by the fact that businesses could be hit with millions of dollars in tax shelter penalties under a provision in the American Jobs Creation Act of 2004, Pub. L. No. 108-357, even when the businesses may have received very little tax benefit. Under the proposed law, the penalty would be 75 percent of the tax benefit received, with a minimum penalty of $10,000 for corporations and $5,000 for individuals. There would also be a maximum penalty of $200,000 for corporations and $100,000 for individuals. The bill would not change the strict liability nature of the penalty (i.e., the IRS does not have the discretion to waive or modify penalties in specific cases) and would require the IRS to submit an annual report to the congressional tax-writing committee on the tax shelter penalties assessed during the prior year. In anticipation of this legislation, IRS Commissioner Shulman has suspended enforcement of the penalties for small businesses. *See* Legislation # 3, *Tax Issues Summary*, July 31, 2009. (Although this legislation may have little impact for insurance companies, it might provide relief for purchasers of §§ 412(I) and 419A plans.)

3. Still Some Hope for a Tax Extenders Bill by the End of the Year

According to a Ways and Means Committee summary, the Tax Extenders Act of 2009 would include approximately $30 billion one-year extensions of otherwise expiring provisions affecting both individuals and businesses. The list of annual extenders includes extensions of the research and development credit, the deduction of state and local general sales tax, the new markets tax credit, and the look-through treatment of payments between related controlled foreign corporations under the foreign

personal holding company rules. The package would be offset by taxing carried interest at the 15 percent capital gains rate, the Stop Tax Haven Abuse Act (H.R. 1265), and an amendment disallowing the prospective use of a new cellulosic biofuels producer tax credit by paper companies seeking to use black liquor to fuel their plants. House Ways and Means Committee Chairman Charles Rangel (D-N.Y.) would like to see this extenders bill acted upon in early December.

Another tax area that could see legislation before year-end is estate tax. Although the Ways and Means Democrats were leaning toward providing just a one-year extension of 2009 estate tax provisions to replace full repeal in 2010, House leadership seems to be leaning toward a permanent extension of the 2009 provisions. More generous substitutes for the 2010 full estate repeal have been offered in the Senate. Though it may be unclear what, it is generally expected that something will be done before 2010.

POLICYHOLDER ISSUES

1. I.R.C. § 61 — Surrender of Life Insurance Policy Results in Ordinary Income, Accuracy Related Penalty Upheld for Lack of Good Faith

In *Barr v. Commissioner*, T.C. Memo. 2009-250, the Tax Court held that upon the surrender of a life insurance policy, the taxpayer was in constructive receipt of the entire cash value proceeds, even though such proceeds were reduced for payment of outstanding loans. Also, the surrender of a life insurance policy resulted in ordinary income, not capital gain, because the surrender was not a sale or exchange of a capital asset. The Tax Court also upheld the accuracy related penalty against the taxpayer concluding that failure to report the income was not due to reasonable cause or in good faith, given the taxpayer's background and experience as an attorney and numerous conversations between taxpayer and the insurance company regarding the tax consequences of surrendering the policy.

2. I.R.C. §§ 104 and 162 — Taxpayer May Deduct Disability Insurance Policy Proceeds

In CCA 200947035 (July, 9, 2009), the IRS Chief Counsel's Office reconsidered CCA 200923025 (Jan. 16, 2009) (*see* Policyholder Issues # 2, *Tax Issues Summary*, June 30, 2009) and determined that a taxpayer is not precluded from taking an I.R.C. § 162 deduction for compensation paid to an employee pursuant to the employment contract merely because the taxpayer received insurance payments on account of employee's disability. I.R.C. § 162 does not allow a deduction for an expense for which there is a right or expectation of reimbursement. However, in the case under consideration, the employer's expense was salary paid under an employment contract that guaranteed the employee's compensation. Although the employer received insurance payments under a disability policy that insured against injury to employees, such payments could be used for any employer purpose, not necessarily related to the injured employee. IRS concluded that there was not a close enough nexus between the

disability insurance payments and the salary expense to connect the two for purposes of denying the deduction. The employer could exclude the proceeds from income because the proceeds were not considered reimbursement for compensation paid to the employee. IRS also concluded that I.R.C. § 265(a)(1) did not apply because the compensation deduction is not allocable to the insurance proceeds received from the disability policy.

3. I.R.C. § 264 — Deduction Allowed for Certain Bank-Owned Life Insurance Policies

In PLR 200945032 (July 17, 2009), the IRS ruled that, upon the surrender of bank-owned life insurance (BOLI) policies for a loss, the owners-taxpayers could recognize the loss with a deduction under I.R.C. § 165(a). For purposes of determining the amount of the loss, the taxpayers' basis in the policies was the sum of the premium payments, plus mortality credits, less the cost of insurance and less the mortality and expense charges (net of mortality experience credits); the amount of the loss deduction for each BOLI policy would be computed by subtracting the basis for each policy from each policy's surrender proceeds. Because the BOLI policies were the subject of a suit by the taxpayers against the issuing insurance company, and because the I.R.C. § 165 deduction is allowed for losses not compensated by insurance or otherwise, no loss deduction was allowed for any portion for which taxpayers had a claim for reimbursement with a reasonable prospect of recovery; such portion of the loss could be claimed in the taxable year where it can be ascertained with reasonable certainty that no such recovery would be received.

4. I.R.C. § 6662 — Insurance Agent's Termination Payments Were Ordinary Income and Subject to Self-Employment Tax

In *Lenard v. Commissioner*, T.C. Summ. Op. 2009-165 (Nov. 9, 2009), the Tax Court determined that payments received by an insurance agent on termination of his agency agreement were ordinary income, not capital gain, since they were based on the quality and quantity of his prior work. The insurance agent argued that the business was sold to the insurance agency and therefore the proceeds qualified for capital gain treatment. Because the agent did not actually sell any assets to the company, the payments were for termination and must be recognized as ordinary income. The court found that the self-employment tax applied to the termination payments because the payments were derived from trade or business carried on by the taxpayer.

COMPANY ISSUES

1. I.R.C. §§ 172(b) and 810(b) — Guidance on New NOL and Operations Loss Carryback Provisions

On November 20th, IRS issued Rev. Proc. 2009-52, 2009-49 I.R.B. __ regarding the recently enacted loss carryback provision in section 13 of the Worker, Homeownership, and Business Assistance Act of 2009 (*see* Legislation, # 1), which allows taxpayers to elect to carry back an applicable NOL

(including a consolidated NOL) or an applicable loss from operations up to 5 years. The election applies to an NOL or operations loss from a taxable year ending after December 31, 2007, and beginning before January 1, 2010.

The new provision amended I.R.C. §§ 172(b) and 810(b) to allow taxpayers to elect to carry back an applicable NOL for a period of 3, 4, or 5 years, or an applicable operations loss for 4 or 5 years, to offset taxable income in those preceding taxable years. This I.R.C. § 172 or § 810 election is irrevocable and, in general, is allowed for only one taxable year. TARP recipients cannot make the election. The amount of an applicable NOL or an applicable operations loss that is carried back to the 5th taxable year preceding the taxable year of the loss is limited to 50% of the taxpayer's taxable income for the carryback taxable year (the excess of the amount of the loss over 50% of the taxable income to be carried forward to later taxable years).

A taxpayer may make an I.R.C. § 172 or § 810 election by attaching an election statement to the taxpayer's federal income tax return (including an amended return) for the taxable year in which the applicable NOL or applicable loss from operations arises, or by attaching an election statement to a Form 1139, Corporation Application for Tentative Refund, or Form 1120X, Amended U.S. Corporation Income Tax Return. A taxpayer must make an I.R.C. § 172 or § 810 election by the due date (including extensions) for filing the return for the taxpayer's last taxable year beginning in 2009. Thus, for this purpose, the due date for timely filing a claim for tentative carryback adjustment on Form 1139 is extended to the due date (including extensions) for filing the return for the taxpayer's last taxable year beginning in 2009. A taxpayer that has elected under I.R.C. § 172(b)(3) or § 810(b)(3) to forgo a carryback for a loss ("carryback waiver election") for a taxable year ending before the date of enactment of the Act – November 6, 2009 – may revoke the carryback waiver election before the due date (including extensions) for filing the return for the taxpayer's last taxable year beginning in 2009.

For a consolidated group having both an applicable NOL and an applicable loss from operations, Rev. Proc. 2009-52 does not answer the question of whether an election can be made for only one type of loss under the Act, or, if for both, whether an applicable NOL or an applicable loss from operations carried back pursuant to the new amendments must be from the same year. Because the applicable NOL or applicable loss from operations can be carried to closed years, in making the election companies should consider whether doing so could open otherwise-closed issues to be used as possible offsets to the carryback benefit.

2. I.R.C. § 808 — IRS Provides Guidance on Deduction of Insurance Company's Annual and Termination Dividends

In TAM 200948042 (Aug. 4, 2009), the IRS concluded that an insurance company may not deduct annual dividends in the year they are posted to an insurance policy when they are posted at the end of the calendar year and become payable on the first month of the following tax year; likewise the company may not deduct the lesser of termination dividends or annual dividends that become payable in the next tax year. I.R.C. § 808(c) states that the deduction for policyholder dividends for any taxable year shall be an amount equal to the policyholder dividends paid or accrued during the taxable year. Under the terms of the policies, taxpayer pays annual dividends on the anniversary date of the policy, provided the policy is in force and all premiums due have been paid up on its anniversary date, so that if

the policy has not been paid up, there is no liability to pay the annual dividend. The IRS rejected the position of the company that its liability for dividends with respect to anniversary dates in January should be treated as fixed in December because the company had a practice of indicating a dividend credit in advance of the anniversary date and even sought to delay requested surrender payments until after the anniversary date. The IRS concluded that the terms of the policies, not the company's informal administrative practice, should control. The IRS also disagreed with the company's argument that its obligation to pay the annual or termination dividends is a fixed liability that should be considered a rebate, refund, or similar payment under Treas. Reg. § 1.461-4(g)(3); the IRS thought the liability falls into the "other" liability category and concluded that the company does not meet the all-events test requirement for economic performance.

3. I.R.C. §§ 832 and 846 — LMSB Releases Coordinated Issue Paper Concerning Non-life Insurance Reserves

The IRS Large and Mid-Size Business Division (LMSB) issued coordinated issue paper LMSB4-1109-041, "Margins and Other Unsubstantiated Additions to Insurance Company Reserves for Unpaid Losses and Claims - 11/18/2009," applicable to both health insurance and property-casualty companies. LMSB states that margins or other additions to unpaid reserves are not allowable for tax purposes if they "are not based upon the company's actual loss experience," if they exceed a fair and reasonable estimate, or if the taxpayer cannot show that they represent only actual losses. The issue paper observes that, because annual statement reserves represent management's best estimate and not an actuary's best estimate, not all annual statement reserves are allowable for tax purposes, and the IRS is not bound by the reserve numbers or the opinion of taxpayer's actuary. It then argues that formula reserves are not allowable because they are not based on actual loss events, that because estimates must be fair and reasonable no margin or tolerance is allowed, and that the tax standard for valuing unpaid losses is different from the annual statement standard. This LMSB coordinated issue paper is largely consistent with the position and arguments taken by IRS agents during audits for quite some time (e.g., a similar position argued by the IRS in *Utah Medical Ins. Assoc. v. Commissioner*, T.C. Memo. 1998-458, and TAM 200115002 (Dec. 21, 2000) was rejected by the court and the IRS National Office). Thus, the issue paper is unlikely to have a significant impact.

4. I.R.C. § 847 — IRS Seeks Comments on Insurers' Loss Discount Form 8816

IRS requested comments on Form 8816, Special Loss Discount Account and Special Estimated Tax Payments for Insurance Companies regarding the extension of information collection activities. This form is used to determine insurance companies' tax benefit and reconcile the estimated tax payments when an additional deduction is claimed under I.R.C. § 847. Specifically, the IRS would like comments addressing: (i) whether the collection of information is necessary for the proper performance of the functions of the agency; (ii) the accuracy of the estimate of the burden of the collection of information;

(iii) ways to enhance the quality, utility, and clarity of the information to be collected; (iv) ways to minimize the burden of the collection of information on respondents; and (v) estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information. Comments should be submitted to Glenn Kirkland, IRS, by January 4, 2010. 74 F.R. 56691 (Nov. 2, 2009).

5. Treasury and the IRS Release the 2009-2010 Priority Guidance Plan

Some five months into the new "plan year," Treasury and the IRS has released its 2009-2010 Priority Guidance Plan. Issues listed specifically for "Insurance Companies and Products" are:

1. Final regulations on the exchange of property for an annuity contract. Proposed regulations were published on October 18, 2006.
2. Guidance on the tax treatment of a partial exchange or partial annuitization of an annuity contract.
3. Guidance on the classification of certain cell captive insurance arrangements. (Previous guidance was published in Notice 2008-19, 2008-5 I.R.B. 366.)
4. Guidance on tax issues arising under §807 as a result of the adoption by the National Association of Insurance Commissioners (NAIC) of an Actuarial Guideline setting forth the Commissioners' Annuity Reserve Valuation Methodology for variable annuities (AG 43).
5. Revenue ruling regarding the tax-free exchange of life insurance contracts subject to §264(f).
6. Guidance clarifying whether deficiency reserves should be taken into account in computing the amount of statutory reserves under §807(d)(6).
7. Guidance on the determination of the company's share and policyholders' share of the net investment income of a life insurance company under §812.
8. Guidance on treatment of age 100 maturity under §7702 based on comments to Notice 2009-47, 2009-24 I.R.B. 1083.
9. Guidance on annuity contracts with a long-term care insurance feature under §§72 and 7702B.
10. Revenue ruling providing guidance on reinsurance arrangements entered into with a single ceding company. (Rev. Rul. 2009-26, 2009-38 I.R.B. 366, has already been published.)

Of the ten items listed, only items 6, 8 and 9 are new and not carried over from last year.

6. IASB Agrees with FASB re Recording No Revenue Offset when Expensing Acquisition Costs in Insurance Contracts

The International Accounting Standards Board (IASB) shifted its stance to agree with the Financial Accounting Standards Board (FASB) that entities should record no revenue offset when expensing acquisition costs in insurance contracts. The boards met on October 28 to resolve their differences on issues of policyholder accounting, measurement objectives, and acquisition costs. Since a 2007 discussion paper was issued, the boards have been negotiating to develop a unified proposal.

FASB's view was that entities should not recognize revenue at the same time acquisition costs are expensed because the insurer should recognize revenue only when it satisfies its performance obligation to its policyholder under the insurance contract. IASB was concerned with how revenue would be applied to insurance and that it would differ from how it would apply revenue to everything else. FASB believed that all industries should have the same revenue recognition model, but that revenue and liabilities could be accounted for differently. FASB seemed willing to include a risk margin in the measurement of insurance contracts, but policyholder accounting issues are still being researched and considered.

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