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the proposed exchange would not involve any material increase in the death benefits and would not effect any other material change in policy terms.

After ruling that the exchange qualified as a tax-free exchange under section 1035, the IRS also held that the policies received in the exchange would not be treated as issued after the effective date of section 101(j) and a companion provision, section 6039I (imposing certain reporting requirements relating to policies subject to section 101(j)), for the reason that section 1035 applied to the exchange. While sections 101(j) and 6039I generally are effective for policies issued after Aug. 17, 2006, a transition rule in the Pension Protection Act excludes from this policies issued after that date in a section 1035 exchange for pre-Aug.17, 2006 policies. The same transition rule, however, further states that this grandfathering is lost if there is "any material increase in the death benefit or other material change" to a contract. The juxtaposition of these concepts within the same rule poses a conundrum of sorts, since the tax law generally considers an exchange to be a material change and *vice versa.* The legislative history of the Pension Protection Act provides no enlightenment on this, although it does state that a change from a general account contract to a separate account contract and a death benefit increase required by section 7702 would not give rise to a material change for this purpose.

While PLR 200715006 confirms that a section 1035 exchange—at least under the facts of that ruling—will not cause a loss of grandfathering under sections 101(j) and 6039I, the utility of this conclusion to other taxpayers is hampered by the fact that the IRS did not address in any way what constitutes a material change in the terms of a contract and how, if at all, that relates to the section 1035 reference in the transition rule. The taxpayer represented that no material change would occur, thus rendering it unnecessary for the IRS to address this legal issue. In view of the legislative history of section 101(j) noted above, it probably is fair to conclude that the IRS would not view a change in the identity of the carrier alone, or a change from a general account contract to a separate account contract, as a material change that would trigger a loss of grandfathering. Further, notwithstanding the fact that the taxpayer represented away the material change issue, it is unlikely that the IRS would have accepted the representation and issued the ruling unless it was comfortable, at least at some level, that the changes involved in the exchange were properly not treated as material changes. That said, however, one should not draw much comfort from the ruling beyond its specific facts, which were cryptic in the IRS's retelling. Technically, only the taxpayer to whom the ruling was issued may rely on it (*see* section 6110(k)(3)), and thus far, only that taxpayer has the comfort of knowing that the facts it showed to the IRS led to a favorable holding under the Pension Protection Act's somewhat confusing transition rule. The downside of being wrong on this issue, of course, is draconian for the policyholder—the loss of tax-free death benefits—and thus the course followed by the taxpayer in seeking the ruling that resulted in PLR 200715006 was well advised.

IRS Rules that Retroactive Reinsurance Is Not Reinsurance for Tax Purposes

by Susan J. Hotine, Peter H. Winslow and Lori J. Jones

In PLR 200711017 (Dec. 14, 2006), the IRS National Office ruled that loss portfolio reinsurance (which is generally accounted for as retroactive reinsurance under SSAP 62) between two related insurance companies does not qualify as insurance for tax purposes, even though the reinsurance satisfied the criteria for risk transfer under SSAP 62 for property and casualty reinsurance and even though the state insurance department confirmed that reinsurance accounting treatment is correct. Because the agreement between the companies covered only loss reserves related to insured events that already had occurred, the ruling notes that "the element of fortuity is absent" and concludes that the agreement transfers only a timing and investment risk. Noting that the taxpayer could not procure an arrangement with similar terms in the commercial reinsurance market because, in part, if the companies were unrelated, the same statutory accounting treatment would not be available, the ruling also concludes that the reinsurance agreement is not insurance in the commonly accepted sense "as envisioned by the caselaw."

The ruling considers an agreement between a reinsurance company and its parent (another reinsurance company) under which the subsidiary company transferred or ceded its liability for losses (including loss adjustment expenses and incurred-but-not-reported losses) to its parent company, for losses occurring no later than a specific year that was several years before the agreement.

The ceding company paid an amount equal to the statutory reserves being transferred, and such amount was placed in a notional account to which a set rate of interest would be credited. The assuming company is obligated to pay any losses covered by the agreement up to an aggregate limit. If at any time the amount of claims exceeds the balance in the notional account, the assuming company must pay the excess up to the aggregate limit; if the balance in the notional account exceeds the claims paid at the end of the contract, the positive balance will be remitted to the assuming company. The facts note that, but for the companies being related, SSAP 62 would require the agreement to be accounted for as retroactive reinsurance. Because the companies are related and because the agreement meets SSAP's criteria for risk transfer, the companies are allowed to account for the agreement as prospective reinsurance.

The IRS granted the ruling that was requested by the taxpayer—that the retroactive reinsurance agreement does not constitute insurance.

The ruling cites Rev. Rul. 89-96, 1989-2 C.B. 114, and the analysis therein for retroactive insurance, apparently applying it to determine whether the reinsurance transaction should be treated in a similar manner for tax purposes. Rev. Rul. 89-96 involves a situation where a direct writer of insurance attempted to "insure" losses from events that already had occurred (otherwise known as retroactive insurance), using an "insurance contract" that placed a cap on the insurer's liability. In addition, it was anticipated that the actual losses would substantially exceed the cap. The ruling concludes that, because the losses already had been incurred by the insured and the insurer's liability exposure was capped, only investment and timing risks were involved, not insurance risks.

In PLR 200711017 the IRS appears to have concluded that the reinsurance contract itself must involve the element of fortuity in order for the transaction to be treated as insurance for tax purposes. This seems to depart from what has been the IRS' administrative position—that, in determining whether reinsurance is valid insurance and whether the liabilities transferred are valid insurance liabilities or reserves, one would look to whether the directly-written contracts are/were valid insurance, recognizing that reinsurance is the method for transferring insurance liabilities between insurance or reinsurance companies. The ruling does not address the fact that the reinsured loss reserves represent valid insurance risks on the books of the ceding company and does not answer why, given this fact, the loss reserves would not also be valid insurance risks for the assuming company.

Moreover, the ruling's reliance on the fact that an arrangement with similar terms is not available in the commercial reinsurance market as support for a conclusion that the agreement is not insurance is questionable. This conclusion appears to be inconsistent with the reasoning in the captive insurance cases, where the fact that commercial insurance is not available is a factor that supports insurance treatment if risk transfer otherwise is present. The ruling seems to be influenced by the fact that under SSAP 62 special accounting treatment is required for retroactive reinsurance. While this is true, that accounting treatment does not negate risk transfer or qualification of the arrangement as reinsurance for regulatory purposes.

The ruling also seems to be in conflict with the I.R.C. § 338 regulations. Where a company is acquired in a stock purchase, I.R.C. § 338 permits the parties to elect to treat the acquisition for tax purposes as if all of the assets were purchased. Treas. Reg. § 1.338-11T requires that, in the case of insurance companies, the deemed asset purchase must be effectuated as if a reinsurance transaction had occurred. The regulations make clear that the reinsurance treatment applies to the transfer of all of the seller's unpaid loss reserves, giving explicit recognition to retroactive reinsurance for tax purposes. It is difficult to reconcile the conclusion of PLR 200711017 with the I.R.C. § 338 regulations except to assume that there must be something unique in the taxpayer's facts unstated in the ruling that dictated a different result.

The IRS granted the ruling that was requested by the taxpayer—that the retroactive reinsurance agreement does not constitute insurance. One might speculate that the ruling was requested so that the payment made by the parent corporation to the subsidiary could be treated as a contribution to capital, or perhaps because the assuming company is foreign and the non-insurance ruling eliminates the application of any excise tax. Informally, IRS personnel have emphasized that the ruling only applies to this particular taxpayer. For this reason, it is questionable whether the IRS will rely on this

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ruling to attack reinsurance accounting in audits of other taxpayers.

Although reason might dictate that the IRS should not conclude that retroactive reinsurance, *per se,* fails to qualify as insurance, it might not prevent the IRS from questioning these arrangements using the retroactive insurance analysis. In a field attorney advice memorandum (FAA 20072502F (May 8, 2007)), the IRS' Associate Industry Counsel Property and Casualty Insurance (Large and Mid-Size Business) also concluded that no insurance risk was transferred in a retroactive reinsurance transaction between unrelated insurance companies. The facts in the memorandum are sketchy, but it appears that the

assuming company reinsured 30 percent of the risks of incurred losses from an unrelated insurer on a funds withheld basis. The assuming company analyzed the transaction under five cash flow scenarios and concluded that it satisfied the criteria for risk transfer under SSAP 62. FAA 20072502F starts from the premise that the analysis applied to retroactive insurance under Rev. Rul. 89-96 must be applied to a reinsurance transaction to determine whether insurance risk is transferred.

Referring to Rev. Rul. 89-96, FAA 20072502F appears to fashion a test to determine whether there has been adequate risk transfer in a reinsurance transaction, explaining it as follows:

> The Service contends that in essence, Revenue Ruling 89-96 equates the tax savings received, when booked as an underwriting loss, to an additional premium which the taxpayer can invest to cover expected claims. Therefore, to evaluate the economics of the transaction, this tax savings along with the actual premium is compared to the net present value (NPV) of the anticipated losses. If the NPV of the anticipated losses do not materially exceed the premium plus the tax savings, the transaction does not transfer insurance risk for federal income tax purposes.

FAA 20072502F applies this test to the assuming company's five scenarios and concludes that, because of the "tax benefits" to the assuming company (which seems to have been identified as the up-front net deduction for reserves), there was no realistic possibility of an economic loss. The memorandum appears to ignore the fact that the "tax benefits" for the assuming company are the same as those already enjoyed by the direct-writer—the recognition of loss reserves. The reinsurance transaction does not create a new tax benefit, but merely transfers the tax benefit of loss reserves from one insurance company to another. This is a contrast to the situation in Rev. Rul. 89-96 where the "insurance" transaction was designed to obtain tax benefits for the taxpayer being "insured" (*i.e.*, an up-front premium deduction). Moreover, The FAA does not consider the full consequences of concluding that the reinsurance transaction does not transfer risk; if it is not reinsurance for the assuming company, then it is not reinsurance for the ceding company and the tax benefits of the loss reserves remain with the ceding company. Also, by focusing on only the assuming party and its potential tax benefit (the up-front net deduction for reserves), the post-tax economic analysis of the FAA's test is circular. The tax benefits derived by the assuming company's up-front reserve deduction causes the FAA to conclude that there is no transfer of risk and therefore the assuming company should be denied the tax benefit. However, once the assuming company has been denied an up-front deduction for the transferred reserves, and that tax benefit is not taken into account, under the FAA's analysis, one would have to conclude that there is transfer of risk, making the transaction insurance, and making the assuming company entitled to an up-front reserve deduction. Moreover, the recent COLI cases suggest that the economic substance of a purported insurance transaction should be analyzed on a before-tax basis. *See American Electric Power Company, Inc. v. United States,* 326 F.3d 737, 743-744 (6th Cir. 2003). Again, it is questionable whether reliance on the retroactive insurance analysis of Rev. Rul. 89-96 is appropriate to determine whether there is risk transfer in a reinsurance transaction.

Up until PLR 200711017 and FAA 20072502F, the analysis associated with retroactive insurance (*i.e.*, whether or not the event insured against had occurred) has not been applied to reinsurance transactions. With reinsurance, there are directly-written contracts and insurance coverage is involved; the only question is whether the risk associated with that coverage has been transferred. The fact that the losses already have been incurred by the insurer under the directly-written contracts should be irrelevant as long as it is reasonably possible that the assuming company will incur a significant loss in assuming all or part of the risk covered by those contracts.

The IRS itself apparently is rethinking whether the principles of Rev. Rul. 89-96 should apply to retroactive reinsurance. Shortly after PLR 200711017 and FAA 20072502F were released, the IRS issued Rev. Rul. 2007-47, 2007-30 I.R.B. 127, which holds that a taxpayer's purchase of "insurance" to cover the future costs of restoring its business location to its condition prior to when the taxpayer's business operations were begun does not qualify as insurance for tax purposes. The business is harmful to people and property, and governmental regulations require the taxpayer to remediate that harm. The ruling reasons that the arrangement lacks the requisite element of "fortuity" because, although the exact amount and timing of the costs to be incurred are not known, it is certain that they will be incurred.[1] At the end of the ruling, the IRS specifically states that the ruling's conclusion does not apply to reinsurance arrangements, including retroactive reinsurance, such as loss portfolio transfers. Nevertheless, the IRS leaves open its option to apply the principles of Rev. Rul. 89-96, and other authorities dealing with directly-written "insurance," to reinsurance on a case-by-case basis, and asks for comments on this topic to be submitted by Oct. 22, 2007. We expect that comments will be filed asking the IRS to clarify that the broad language of PLR 200711017 and the test set forth in FAA 20072502F should not be followed by the IRS.

IRS Issues Exam Guidelines to Promote Consistency

by Samuel A. Mitchell

In recent months various IRS and Chief Counsel officials have made public statements regarding the need for consistency in examinations of large corporate taxpayers. For example, readers who attended the Federal Bar Insurance Tax Conference heard Chief Counsel Korb highlight successful efforts in recent months to issue more guidance for field agents and taxpayers. Nevertheless, the IRS seems to have had some difficulty asserting control over high-profile issues. This may be the result of a reorganization that occurred late last year to realign IRS resources more along geographic lines. In order to remedy the perceived problem with inconsistency, the Large and Mid-Size Business Division (LMSB) recently published new "rules of engagement" for the examination of large and mid-size taxpayers. LMSB refers to the new rules as its Industry Issue Focus approach.

Under the new rules of engagement, contained in section 4.51.1 of the Internal Revenue Manual, LMSB has divided examination issues into a three-tiered system. Tier I issues are those that the IRS thinks present the most risk for non-compliance. The Tier I list currently includes all listed transactions (transactions the IRS has designated as potentially abusive tax shelters) and 14 other issues. Under the new rules, LMSB has appointed a single IRS employee as the Issue Owner Executive for each Tier I issue. The new rules establish a protocol under which examiners must coordinate the resolution of each Tier I issue through the Issue Owner Executive. Under the protocol for Tier I issues, examiners will have no discretion in applying guidance to a taxpayer's facts and circumstances and the Issue Owner Executive has nationwide jurisdiction including issue resolution.

Tier II issues currently include 11 important general issues that present what the IRS considers to be an elevated compliance risk. LMSB has appointed an Issue Owner Executive through which each Tier II issue must be coordinated; however, examiners will have some discretion in resolving Tier II issues. Tier III issues present less compliance risk and hence call

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[1] Rev. Rul. 2007-47 follows a number of IRS Chief Counsel memoranda that hold that contracts that would indemnify a nuclear power plant for future decommissioning costs do not qualify as insurance. CCAs 200629028 and 200629029 (Apr. 14, 2006); CCA 200703007 (Jan. 19, 2007).

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In keeping with the IRS's recent efforts to centralize control, insurance companies can expect only increased scrutiny and a centralized, coordinated approach from the IRS, and the industry should not be surprised if issues appear on the Industry Issue Focus Approach lists.

for less coordination, but are still important. Currently, the IRS has not put any issues on the Tier III list. The Tier I, II and III issues will appear on the IRS's Web site (www.irs.gov) as they are designated. There are links to Directives on most of the identified issues, and some of the Directives identify sub-issues for consideration. A special committee within LMSB will designate Tier I and II issues, and the Field will designate Tier III issues.

There are no insurance-specific issues on the Tier I or Tier II lists.[1] There is, however, at least one general tax issue on the Tier I list that is prevalent in the industry. The issue involves the application of I.R.C. § 162(f) to settlement payments to the government. I.R.C. § 162(f) disallows the deduction of a fine or penalty paid to the government as the result of a violation of the law. As a follow-up to the Industry Issue Focus approach, the IRS recently released a Directive on the I.R.C. § 162(f) issue. (Industry Director Directive on Government Settlements Directive #1, LMSB-04-0507-042.) Many health insurance companies have had the issue in recent years. In fact, the IRS states in the Directive that over 75 percent of settled cases involve health care fraud, primarily regarding Medicare payments. These cases involve False Claim Act (FCA) cases brought by the government. The controversy involves the allocation of settlement payments between those imposed to encourage prompt compliance with the law or as a remedial measure to compensate another party, which are deductible, and those imposed in order to enforce the law and punish the violator, which are not deductible. The Directive provides guidance regarding how to draw the line between the deductible and non-deductible portions on a facts-and-circumstances basis and requires the examiner to coordinate with the Department of Justice attorney who handled the settlement in all FCA settlements that exceed $10 million. There may be more activity on this issue in the near future, as Wellpoint, Inc. currently is litigating the issue in the Tax Court. (Wellpoint, Inc. v. Commissioner, Doc. No. 13585-05, USTC, filed July 21, 2005).

A second issue, on the Tier II list, may touch the insurance industry's treatment of bad debt deductions in the mortgage business. The issue is labeled as the "non-performing loans" issue. It probably is intended to address how banks account for the timing of bad debt deductions on non-performing loans, but there is no way to tell at this point whether the insurance industry will be swept into the issue coordination because the IRS has not yet published a Directive or specifically referred to existing guidance on the issue.

Although no core insurance tax issues have yet been designated, this does not mean that insurance companies will be subject to a lesser level of audit scrutiny. Insurance tax issues already are subject to an increasingly coordinated approach with heavy involvement by IRS actuaries and at least two Chief Counsel attorneys who specialize respectively in life and property/casualty insurance issues. In keeping with the IRS's recent efforts to centralize control, insurance companies can expect only increased scrutiny and a centralized, coordinated approach from the IRS, and the industry should not be surprised if issues appear on the Industry Issue Focus Approach lists.

No Section 1035 Exchange Where Taxpayer Endorses Received Check to Second Life Insurance Company

by Mark E. Griffin and Michelle A. Garcia

On May 2, 2007, the Internal Revenue Service (IRS) released Rev. Rul. 2007-24, 2007-21 I.R.B. 1282, in which it held that the receipt of a check from a life insurance company under a nonqualified annuity contract, followed by the endorsement of the check to a second company as consideration for a second annuity contract, does not qualify as a tax-free exchange under section 1035 of the Internal Revenue Code. The IRS has taken this position in a number of private letter rulings that have limited application to the taxpayers who requested the rulings,[1] and the IRS apparently felt the need to publish guidance of more general applica-

[1] At the time of publication, there may be more issues on the Tier I, II and III lists than referenced above.

bility on this issue. The IRS, in Rev. Rul. 2007-24, appears to reject the position taken by the Tax Court in *Greene v. Commissioner,* 85 T.C. 1024 (1985), that tax-free treatment under section 1035 applies under similar facts. It is interesting to consider whether the IRS might have reached a different conclusion in Rev. Rul. 2007-24 if the transaction at issue involved slightly different facts, as discussed below.

Section 1035(a) provides generally that no gain or loss is recognized on certain exchanges of insurance products, including the exchange of an annuity contract for another annuity contract. For purposes of section 1035, it is clear that an exchange of a contract can be accomplished by assigning the contract directly to a new insurer as consideration for a new contract.[2] The IRS has traditionally taken the position that where a taxpayer receives funds from the surrender of one annuity contract and immediately applies such funds to the purchase of a second annuity contract, such transaction does not qualify as a tax-free exchange under section 1035.[3] The IRS likewise has taken this position where a taxpayer receives a check from a life insurance company for the surrender of an annuity contract and endorses the check to another life insurance company as consideration for the issuance of another annuity contract.[4]

Rev. Rul. 2007-24 involves an individual who owned a nonqualified annuity contract issued by a life insurance company (IC1). The individual, intending for the transaction to be treated as a tax-free exchange under section 1035, requested that the first life insurance company, IC1, issue directly to another life insurance company (IC2) a check as consideration for a new annuity contract to be issued by IC2. IC1 refused the individual's request and, instead, issued the check to the individual. Upon receiving the check, the individual endorsed the check directly to IC2 as consideration for a new annuity contract. The IRS concluded generally that the transaction did not qualify for tax-free treatment under section 1035, and that the amount of the check was "an amount not received as an annuity" that was taxable to the extent of any gain on the original contract under the so-called "income-first" rule under section 72(e).

In reaching this conclusion, the IRS reasoned that there was no actual exchange of annuity contracts, the individual did not assign the IC1 contract to IC2, and there was no direct transfer from IC1 to IC2 of the cash value of the old contract in exchange for the new contract. The IRS stated in the revenue ruling that "[n]either § 1035 nor the regulations make any special provision for the purchase of an annuity contract with amounts distributed to the policyholder under another contract." In addition, because the annuity contract was a nonqualified contract, none of the tax-free rollover provisions set forth in the Internal Revenue Code, such as the provision provided in section 403(a)(4), apply to the amounts received from the IC1 contract.

The question remains whether a court might hold that the transaction in Rev. Rul. 2007-24 constituted a tax-free exchange under section 1035, based on the rationale of the Tax Court in the *Greene* case. The *Greene* case involved a taxpayer who held a section 403(b) annuity contract issued by a life insurance company, which she surrendered for the payment of proceeds in 1980,

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1 See Internal Revenue Code section 6110(k)(3).

2 John T. Adney, Joseph F. McKeever III, & Barbara N. Seymon-Hirsch, *Annuities Answer Book* 7-51, Q 7:70 (4th ed. 2005) ("An exchange of contracts typically involves the assignment of a contract to an insurer for the issuance of a new contract"); *see also* Rev. Rul. 72-358, 1972-2 C.B. 473 (assignment of a life insurance contract issued by one insurance company to a second insurance company in exchange for a variable annuity contract issued by the second company is treated as a tax-free exchange under section 1035); Rev. Rul. 2002-75, 2002-2 C.B. 812 (concluding that an assignment of an annuity contract issued by one insurance company to a second insurance company, which then deposits the cash surrender value of the assigned annuity contract into a pre-existing annuity contract owned by the same taxpayer, and issued by the second insurance company, is a tax-free exchange under section 1035).

3 *See, e.g.,* PLR 200622020 (Feb. 8, 2006) (concluding that, for purposes of sections 72 and 1035, where the full amount of an annuity contract had been distributed to the grantor trust, the taxpayer was not entitled to roll over the amount received into another annuity contract or to use the proceeds received to purchase a second annuity contract in a transaction that qualifies for tax-free exchange treatment under section 1035); and PLR 8310033 (Dec. 3, 1982) (concluding that the proposed surrender of a group annuity certificate and subsequent purchase of a new annuity contract with the surrender proceeds is not a tax-free exchange under section 1035).

4 *See, e.g.,* PLR 8515063 (Jan. 15, 1985) (concluding that the proposed surrender of an annuity contract and subsequent purchase of another annuity contract with the surrender proceeds, even where the taxpayer proposed to directly endorse the check received from the surrender of the first annuity contract to the issuer of the second annuity contract, is not a tax-free exchange under section 1035).

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intending to use the proceeds to purchase a new section 403(b) annuity contract from another life insurance company. Shortly after receiving the check from the first life insurance company she endorsed the check to the second life insurance company in exchange for a new 403(b) annuity contract. In *Greene,* the Tax Court held, over the IRS's objection, that such transaction qualified as a valid section 1035 exchange. The court, in reaching its conclusion, stated that it was satisfied that "Congress intended the use of the word [exchange] in [a] broader sense, as where the taxpayer gives up an insurance contract with one company, in order to procure the same or a comparable contract from another company." The court also noted that Treas. Reg. section 1.1035-1 "requires only that the insurance contracts be of the same type, *e.g.*, an annuity for an annuity, and that the obligee under the two contracts be the same person."

Query whether a court presented with the facts in Rev. Rul. 2007-24 would adopt the Tax Court's reasoning in the *Greene* case and, contrary to the IRS's position in that ruling, hold that the transaction involved constitutes a tax-free exchange under section 1035. It appears that the Tax Court's reasoning in *Greene* is equally applicable today. On the other hand, perhaps changes in the tax law since the *Greene* case might affect whether a court today would apply section 1035 in the same manner as the Tax Court in the *Greene* case.

In particular, as mentioned above, the *Greene* case involved a transaction intended to qualify as a tax-free transfer between section 403(b) arrangements. The transaction occurred prior to the IRS's issuance of Rev. Rul. 90-24, 1990-1 C.B. 97, which allows tax-free trustee-to-trustee transfers between section 403(b) arrangements. In addition, the transaction in Greene occurred prior to the enactment of the eligible rollover rules under sections 401(a)(31) and 403(b)(8) that allow tax-free rollovers of certain distributions from "eligible retirement plans," including rollovers between section 403(b) arrangements. The court may have been sympathetic to the taxpayer in *Greene* because section 1035 appeared to provide the only basis to accomplish the desired tax-free transfer in that case. Today, the type of transaction in the *Greene* case would be covered by the eligible rollover rules and, as such, presumably a court today would not apply section 1035 to such transactions. However, it is not clear why the existence of other permissible methods of accomplishing a tax-free transfer should affect whether a transaction like the one in *Greene,* and the similar transaction in Rev. Rul. 2007-24, qualifies for tax-free exchange treatment under section 1035.

It is interesting to note that the IRS indicated generally in *Greene* that it would have treated the transaction in that case as a tax-free exchange under section 1035 if the check to the taxpayer was endorsed over to the new insurer pursuant to a binding agreement with the new insurer to purchase a new annuity contract. The IRS in Rev. Rul. 2007-24 does not address what effect, if any, such a binding agreement might have on the IRS's position in that ruling. It is unclear whether the IRS continues to be of the view it took in *Greene* that the endorsement of a check from an insurance company under a contract pursuant to a binding agreement with a new insurance company qualifies for tax-free treatment under section 1035. If so, the IRS would have reached a different conclusion in Rev. Rul. 2007-24 if the taxpayer and the new insurer entered into such a binding agreement.

FIN 48 Developments

by Samuel A. Mitchell

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The IRS has released two internal documents regarding FIN 48. The first, a May 10, 2007 Memorandum from LMSB Commissioner Deborah Nolan, provides general information to LMSB executives, managers and examiners regarding the IRS's current policies and possible future developments regarding FIN 48.[1] The Memorandum confirms IRS Chief Counsel's opinion that FIN 48 Workpapers are Tax Accrual Workpapers subject to the IRS's current policy of restraint.[2] Under the current policy of restraint, the IRS will not request Tax Accrual Workpapers from a taxpayer unless certain defined circumstances exist (*e.g.*, if the taxpayer does not disclose a transaction the IRS has listed as a potentially abusive tax shelter).[3] It also announces the creation of an LMSB Tax Accrual Workpapers Cadre whose members will assist examiners in requests for Tax Accrual Workpapers under the policy of restraint, a new requirement for six hours of Continuing Professional Education regarding FIN 48, the release of an Audit Field Guide, and provides another reminder

[1] *Memorandum For Executives, Managers, and Examiners–Large and Mid-Sized Business Division* (May 10, 2007, LMSB-04-0507-044).

[2] *Memorandum from Donald Korb, IRS Chief Counsel, Subject: FIN 48 & Tax Accrual Workpapers,* AM 2007-0012 (March 22, 2007).

[3] *Internal Revenue Manual,* IRM 4.10.20.

that the IRS is reviewing and reconsidering its current Tax Accrual Workpaper policy of restraint.

The second document is the Audit Field Guide referenced in Ms. Nolan's Memorandum.[4] The Field Guide describes the general FIN 48 process for identifying and accounting for uncertain tax positions and poses 10 questions and answers about how examiners should deal with the new accounting standard and the disclosures there under. The Questions and Answers provide interesting insights into what the IRS is thinking about the FIN 48 process. For example, in answer to the first question, "Are FIN 48 Disclosures a Roadmap for the IRS?," the Field Guide acknowledges that FIN 48 footnote disclosures in financial statements may not specifically identify issues, but it nevertheless encourages examiners to seriously consider the disclosures in their examination planning process. It encourages examiners to not be reluctant to pursue matters mentioned in FIN 48 disclosures, while still being mindful of the current Tax Accrual Workpaper Policy of restraint. What this may mean, practically speaking, is that IRS examiners may issue broad Information Document Requests (IDRs) that are driven by FIN 48 disclosures but do not expressly ask for audit workpapers relating to the issue. As an example, the Field Guide suggests that if a taxpayer discloses a FIN 48 liability concerning Subpart F income but does not reflect any Subpart F income on its return, IDR questions should be issued requesting an explanation.

The other nine Questions and Answers in the Field Guide deal with extensions of tax years through restricted consents, the use of closing agreements and the effectively settled standard under FSP FIN-48-1, among other things. Its analysis of the effectively settled standard is one of the more interesting points in the Field Guide. In a nutshell, the effectively settled standard allows a company to release a FIN-48 liability regarding an uncertain tax position if the taxing authority has examined the tax year and closed its examination. If the statute of limitations is still open, the company may release the liability if the tax year is "effectively settled," meaning that it is "highly unlikely" that the taxing authority will reopen the examination. The Field Guide reminds examiners of the IRS's general policy that it will not reopen an exam year after it has been closed unless exceptional circumstances exist. The policy regarding reopening of closed years is stated in the Internal Revenue Manual at IRM 1.2.1.4.1 P-4-3 (12-21-1984) and in Rev. Proc. 2005-32, 2005-23 I.R.B. 1206. Interestingly, the Field Guide highlights the exceptional circumstances standard and acknowledges that "it is possible that reopenings will occur more frequently because of the potentially increased availability of information warranting reopening." The exceptional circumstances are 1) fraud, misrepresentation or concealment of a material fact; 2) a substantial error based on an IRS position that was established at the time of the exam; or 3) a serious administrative omission. See IRM 1.2.1.4.1 P-4-3 (paragraph 1). Examiners rarely attempt to reopen under these exceptional circumstances, perhaps because I.R.C. § 7605(b) discourages it and the above IRM provision and Rev. Proc. 2005-32 require prior approval by an IRS executive. As things stand now, it usually can be said that it is unlikely that an exam will be reopened, but how the IRS will react to large FIN 48 releases on effective settlement remains to be seen.

The Field Guide describes the general FIN 48 process for identifying and accounting for uncertain tax positions and poses 10 questions and answers about how examiners should deal with the new accounting standard and the disclosures there under.

New Ruling on Section 264(f) and Insurance Company Owned Life Insurance

by John T. Adney and Michelle A. Garcia

The Internal Revenue Service (IRS) recently issued an adverse private letter ruling (dated May 3, 2007) addressing the income tax treatment under Subchapter L of life insurance held by an insurance company, as owner and sole beneficiary, covering the lives of its officers, employees, and directors (insurance company owned life insurance or I-COLI). The ruling was released to the American Council of Life Insurers (ACLI) by the taxpayer and is scheduled to be released to the public by the IRS in early August.

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[4] *FIN 48 publications LMSB Field Examiner Guide* (May 2007, LMSB 04-0507-045).

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Background

When Congress enacted section 264(f) in 1997, it chose not to apply that provision to insurance companies. Rather than disallowing interest expense deductions under section 264(f) with respect to "unborrowed cash values" of life insurance coverage obtained by the taxpayer on insureds other than officers, employees and directors, Congress imposed rules causing the loss of reserve deductions in such a case where the taxpayer was an insurance company subject to taxation under Subchapter L (sections 801-848 of the Internal Revenue Code). (Congress knew that disallowing interest expense deductions would have only limited effect on insurance companies.) Specifically, if a life insurance company holds life insurance policies with unborrowed cash values otherwise described in section 264(f), the amount of the reserve increase or decrease taken into account in computing the company's taxable income is adjusted to reflect such unborrowed cash values. *See* sections 264(f)(8)(B), 807(a)(2)(B), and 807(b)(1)(B). In the case of a non-life insurance company holding such policies, the amount of the company's losses incurred deduction is reduced. *See* 832(b)(5)(B)(iii). These rules essentially treat the cash values of such policies in the same manner as other tax-favored income items under the so-called proration rules.

While insurance companies are thus subject to their own deduction disallowance regime rather than the interest deduction disallowance regime in section 264(f), the two regimes are linked together and were enacted in tandem by the same section of the Tax Relief Act of 1997. In addition, the deduction disallowance rules for insurance companies state that they apply only to "life insurance policies and annuity and endowment contracts to which section 264(f) applies." *See* sections 805(a)(4)(C)(ii), 805(a)(4)(D)(iii), and 832(b)(5)(B)(iii).

To date, insurance companies and their tax advisors generally have read the phrase "contracts to which section 264(f) applies" to mean that life insurance contracts excepted from the interest deduction disallowance rule of section 264(f) (*e.g.,* contracts that cover officers, employees and directors and thus fall within the section 264(f)(4)(A)(ii) exception) are not "contracts to which section 264(f) applies." This interpretation permits insurance companies, like banks and other corporations, to purchase life insurance on their officers, employees and directors without losing income tax deductions.

The Ruling

In this new ruling, the IRS addressed the meaning of the phrase "contracts to which section 264(f) applies" but concluded, instead, that life insurance policies purchased by an insurance company on its officers, employees and directors are described in that phrase. Accordingly, under the ruling, an insurance company holding such contracts will have reserve or losses incurred deductions disallowed even where the contracts are described in the section 264(f)(4)(A)(ii) exception. In reaching its conclusion, the IRS reasoned that the language of the exception in section 264(f)(A)(ii) is that section 264(f)(1) will not apply to contracts that qualify for the exception, *i.e.*, contracts covering officers and employees are excluded *only* from section 264(f)(1), *not section* 264(f) in its entirety. Consequently, the IRS determined that the exceptions in section 264(f)(4) do not apply in the case of I-COLI and, as such, unlike banks and other corporations, insurance companies are not entitled to the benefit of the section 264(f) exceptions.

This conclusion is based solely on the IRS's reading of the applicable statutory provisions—which differs from the industry's reading of those provisions—and does not address any possible policy reasons for denying insurance companies the benefit of the section 264(f) exceptions that are provided to banks and other corporate policyholders. Because of the ruling's potentially great significance and its highly doubtful rationale, efforts are underway to have the ruling reexamined within the IRS. Hopefully, the ruling will be revoked in the not too distant future, to be replaced with guidance reaching a contrary, and supportable, holding.

Editor's Note: As of Aug. 23, 2007, the IRS had not taken any further action with respect to this ruling.