2003 The year in review

# Continuing developments in the taxation of insurance companies

PricewaterhouseCoopers

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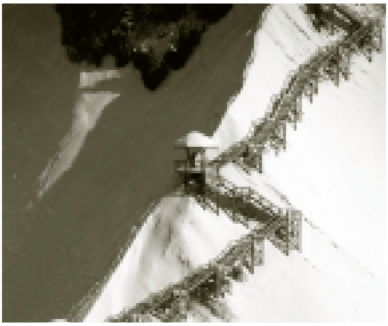

The year in review 2003

## Forward

This monograph provides an overview of developments affecting the taxation of insurance companies. We have selected for specific review those developments of major significance to the insurance industry.

An outpouring of cases and rulings would presumably increase our knowledge and provide clarity with regard to previously clouded areas. As often occurs, however, the cases and rulings generate as many questions as they answer. Nonetheless, it is important to recognize the impact of these cases and rulings on current income tax filing requirements, as well as future tax planning; the tax consequences are both immediate and far-reaching.

PricewaterhouseCoopers LLP

Global Insurance Industry Services Group, Americas

Washington National Tax Services

January 2004

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chapter 1

In many respects, 2003 was the sequel to 2002. While 2002 began the war on terrorism, accounting scandals, tax shelters, and the battle for a recovering U.S. economy, 2003 saw the capture of Saddam Hussein, the installation of the Public Accounting Standards Board's accounting rules, final tax shelter regulations, and the buds of a recovering economy.

As U.S. soldiers fought terrorists in Afghanistan and Iraq, and U.S. Government agents raided "financial terrorists" companies and financial records, it seemed that President Bush's push to drive out "terrorism" was having an effect on the way societies and businesses conducted their day-to-day activities. Whatever the cause, it was almost certainly having an effect on the economy. After 2002's dreary performance, gains in productivity, employment, and the stock market were a welcome change. During December, the Dow broke 10000 for the first time in 2 years, and the Nasdaq topped 2000, gaining fifty percent for the year. Though the Nasdaq is far from its record close above 5000, investors and traders were quick to note that the gains are not the result of over-exuberance, but rather low interest rates and a recovering economy.[1]

[1] E.S. Browning, "Nasdaq's Surge for the Year Hits 50%," *The Wall Stre*et Journal, Dec. 30, 2003, C1.

Buoying the stock market gains were a rise in productivity and an increase in employment. U.S. productivity rose in the third quarter at a 9.4% annual rate for nonagricultural workers, the fastest pace in 20 years.[2] For the two years ended September 30, productivity growth averaged 5.5%, the best two-year performance since 1953.[3] In addition, the U.S. jobless rate fell to a 14-month low in December.[4] The Labor Department reported the unemployment rate fell to 5.7%, its lowest level since October 2002.[5] Despite the good news, the employment report showed that few jobs had been created, which lead critics, in particular Democratic presidential candidates, to question the reality of the economic recovery.

Even in the face of some negative news, it was hard to argue that the economy was worse off in 2003 than it was at the end of 2002. During the year, many events came together to change the shape of the economy. Some of those major news events follow:[6]

**January:** President Bush, in his State of the Union Address, declared he was ready to take on Iraq as well as the economy. In addition, he outlined an aggressive domestic agenda of tax cuts, a Medicare drug benefit, and medical malpractice caps.

**February:** Sprint announced that it forced out its two top executives as a result of their use of questionable tax shelters.

[2] Greg Ip and Joseph Rebello, "Productivity Rises at 9.4% Rate – Best Performance in 20 Years Bolsters Corporate Profits, But May Not Be Sustained" *The Wall Street Journal*, Dec. 4, 2003, A2.

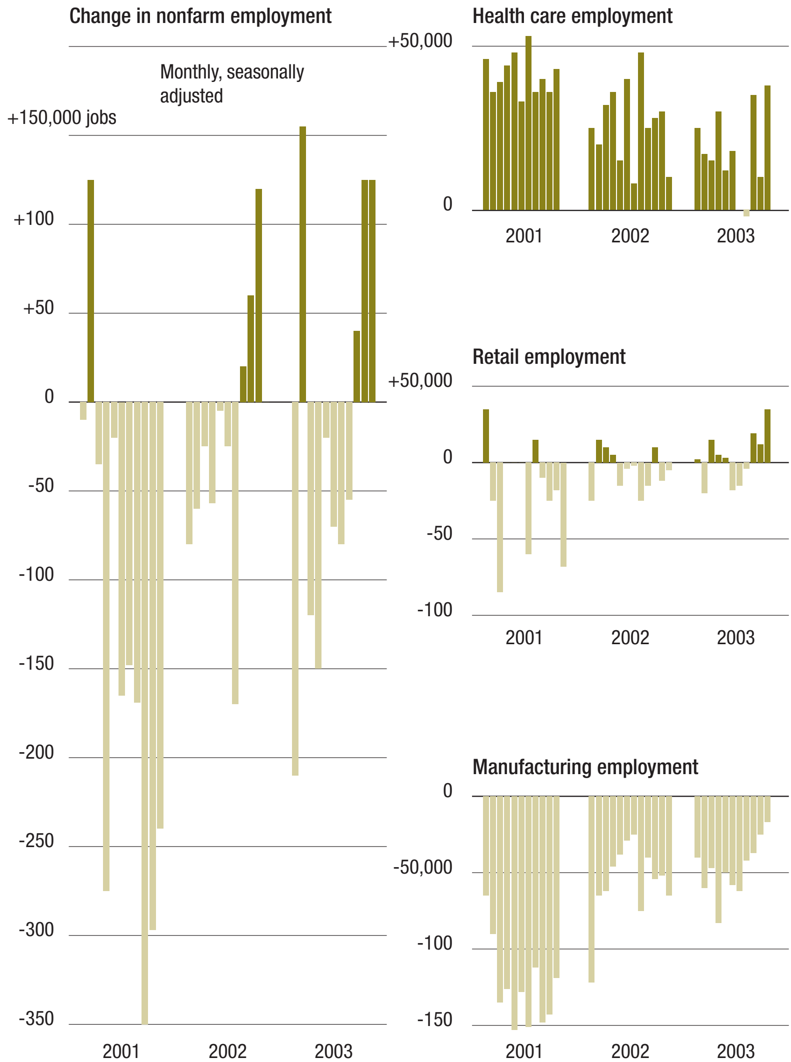
[3] Greg Ip and Joseph Rebello, "Productivity Rises at 9.4% Rate – Best Performance in 20 Years Bolsters Corporate Profits, But May Not Be Sustained" *The Wall Street Journal*, Dec. 4, 2003, A2.

[4] Jon E. Hilsenrath, "Scant Job Growth Forces Jobless To Stop Looking Despite Recovery," *The Wall Street Journal*, Jan 12, 2004, A2.

[5] Jon E. Hilsenrath, "Scant Job Growth Forces Jobless To Stop Looking Despite Recovery," *The Wall Street Journal*, Jan 12, 2004, A2.

[6] Brian Hershberg, Phil Izzo, John C. Long and Kathleen H. Sison, "Year-End Review of Markets & Finance 2003 – War & Recovery," *The Wall Street Journal*, Jan. 2, 2004, R8.

## 3 Months of job growth best in 3 years




*Source: The New York Times*, Nov. 8, 2003, A1.

**March:** The U.S. initiated operations to disarm Iraq with an air raid in Baghdad, and the SEC accused HealthSouth and its CEO of accounting fraud, alleging that they overstated earnings by $1.4 billion since 1999 to meet Wall Street estimates.

**April:** President Bush signed an $80 billion spending bill to cover war costs, including funds for homeland security and airline relief.

**May:** MCI agreed to pay investors $500 million to settle fraud charges of the former WorldCom, which was involved in the biggest accounting scandal in U.S. history.

**June:** The SEC forced six former and current Xerox executives to pay $22 million in fines and other penalties to settle civil fraud charges related to overstated revenues and profits.

**July:** Citigroup and JP Morgan Chase agreed to pay a total of $305 million to settle actions related to loans and trades made with Enron and Dynegy.

**August:** The largest electric power blackout in history hit eight U.S. states and Canada, including New York, Toronto, Cleveland, and Detroit, affecting 50 million people.

**September:** Manulife agreed to buy John Hancock for $10.3 billion in stock, a deal that would make the Canadian firm the second-largest life insurer in North America.

**October:** The U.S. budget deficit more than doubled to $374 billion in fiscal 2003.

**November:** HealthSouth's former chairman, Richard Scrushy, was indicted on 85 counts related to HealthSouth's accounting scandal, including fraud, money laundering, and violating the Sarbanes-Oxley corporate-crime law. Also, Travelers and St. Paul agreed to merge in a $16.4 billion stock deal that created one of the largest U.S. property-casualty insurers.

**December:** President Bush signed legislation adding a prescription drug benefit to Medicare, and Iraq's former dictator, Saddam Hussein, was captured by U.S. forces.

## On the hill

The 2004 election year seemed to be on every legislator's mind, and it showed in the tense relations between Congressional Democrats and Republicans. Relations were so poor as to make it almost impossible to get bills out of committee, much less pass significant legislation and send it on to conference. As a result, only two major bills were passed and signed into law during 2003.

### Economic stimulus bill

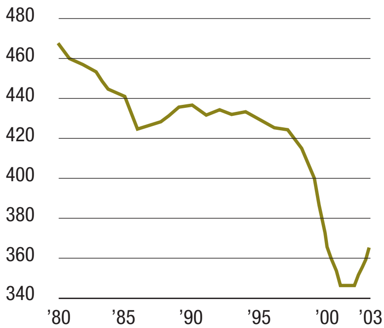
The Jobs and Growth Tax Relief Reconciliation Act of 2003, which was passed in late May, largely rode on the coattails of the 2002 economic stimulus bill by extending bonus depreciation provisions, accelerating the marriage penalty and child tax credit provisions, and reducing individual income tax rates. While the final bill did not eliminate the double taxation of dividends for corporations as Bush had hoped, significantly, the bill did contain capital gains and dividend tax relief for individuals.

The final bill was hotly contested in the Senate, with Vice President Dick Cheney casting the tie-breaking vote. The bill was also controversial for the insurance industry, which had lobbied for changes to the bill to protect its annuity business. Although the Bush Administration had promised it would seek a way to reduce the plan's impact on the insurance industry—and particularly on people who buy annuities—the final bill left out a resolution of the annuity problem. The industry has continued to lobby the Treasury Department following passage of the bill, but no changes have been made.

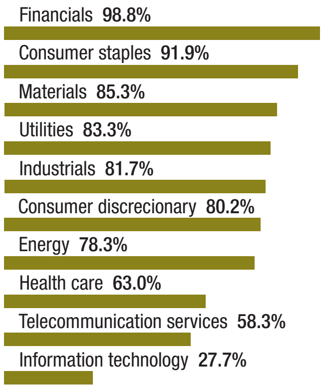
### Return of the dividend

Companies have embraced this year's dividend-tax cut, raising the overall amount of payouts to record levels. Next year investors may start to take notice, boosting sectors that are known for paying high dividends.

Number of companies in the S&P 500 paying dividends




Percentage of companies in a sector that pay dividends




*Source:* Ken Brown, Dividend Stocks Could Become Favorites in '04, *The Wall Street Journal*, Dec. 29, 2003, C1.

## Medicare prescription drug bill

In late November, Congress passed and President Bush signed, a Medicare prescription drug bill (H.R. 1) that included $24 billion in health-related tax cuts. Although the bill had the support of the powerful AARP special interest group, it was maligned by Congressional Democrats as a "cynical bait-and-switch."[7] The Medicare Prescription Drug and Modernization Act of 2003 created $6.7 billion in new tax-preferred savings accounts (HSAs), a tax-free employer subsidy, and changes to disclosure laws that would permit the Department of Health and Human Services to administer a means testing program. Altogether, the $395 billion Medicare bill included roughly $24 billion worth of tax provisions

[7] Patti Mohr , "Bush Signs HSAs, Tax-Free Employer Subsidy Into Law," *Tax Notes Today*, 2003 TNT 236-2, Dec. 8, 2003.

that would be offset by projected revenue gains that the new drug benefit subsidy would indirectly produce.[8] Two Democratic presidential candidates, Senator John Kerry, (D, MA), and Senator Joseph Lieberman, (D, CT), did not vote on the bill.[9]

The bill may turn out to be a boon for insurers. Companies are already examining the legislation and meeting with experts to devise plans that will take advantage of the new HSAs that the bill created. Because tax-payers can use tax-deductible HSA contributions to pay for long term care insurance and some kinds of temporary health insurance, passage of H.R. 1 also could help insurers sell those products to workers who enroll in the new defined contribution health plans.[10]

## The war on terrorism: round two

On December 15, 2003, President Bush, U.S. soldiers, and citizens around the world breathed a collective sigh of relief when Iraq's U.S. administrator L. Paul Bremer announced, "Ladies and Gentlemen, We got him!" With Saddam Hussein in U.S. custody, the war in Iraq suddenly seemed to be going better. As a result of Saddam's capture, President Bush's approval rating jumped from a low of 50 percent[11] to 60 percent at year-end.[12]

Except for a blip just before the war began in Iraq, demand for government-backed terrorism risk insurance has remained slight.[13] An influential survey of insurance brokers found that seventy-five percent of customers

[8] Patti Mohr, "Senate Sends Medicare Tax Riders to Bush, Considers Options on Energy," *Tax Notes Today*, 2003 TNT 228-1.

[9] Allison Bell, "H.R. 1 - More Than Medicare Reform," National Underwriter Life and Health-Financial Services Edition, Nov. 26, 2003, no page.

[10] Allison Bell, "H.R. 1 - More Than Medicare Reform," National Underwriter Life and Health-Financial Services Edition, Nov. 26, 2003, no page.

[11] Richard Benedetto, "Poll finds Bush's job approval at 50%," *USA Today* Online, Nov. 17, 2003.

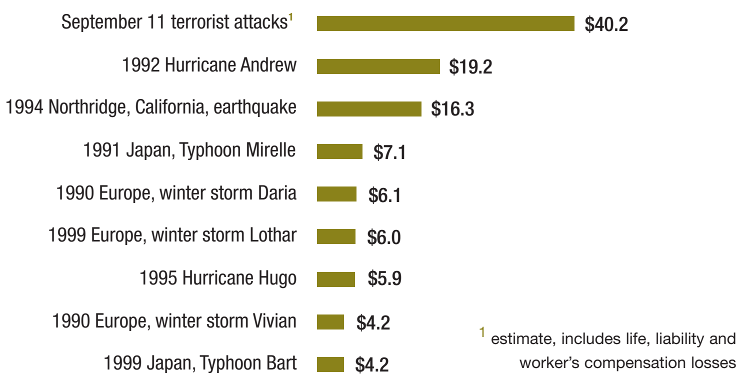
[12] CNN/USA Today/Gallup Poll, Dec. 16, 2003, A1.

[13] Holman W. Jenkins, Jr. "Insurance News Flash: The Terrorists Aren't Winning," *The Wall Street Journal*, Sept. 10, 2003, A25.

turned down the coverage because they felt they did not need it.[14] "The Main Street business owner is not concerned about terrorism and is not interested in terrorism insurance," the CEO of Community Insurance Center in Chicago told USA Today in April.[15] Further, one study showed that the amount of money that corporations spend on security has not budged following the September 11 terrorist attacks.[16]

## Largest insured losses

The September 11 terrorist attacks caused the biggest insurance loss in history. World's top insured losses (in billions):




*Source:* "Many Firms Shun Federal Terrorism Insurance," *USA Today*, Apr. 2, 2003, 6B.

Even as the Government's terrorism reinsurance program was fading, things seemed to be turning around for private reinsurers. The Wall Street Journal reported in July that reinsurers "have rebuilt much of the billions in capital lost during the past few years due to the attacks, rising liability costs, and weak investment returns." The report continued, "Reinsurers also have… asked primary insurers to take on more risk than they have

[14] Holman W. Jenkins, Jr. "Insurance News Flash: The Terrorists Aren't Winning," *The Wall Street Journal*, Sept. 10, 2003, A25.

[15] Christine Dugas, "Many Firms Shun Federal Terrorism Insurance," *USA Today*, Apr. 2, 2003, 6B.

[16] "Study – Insurance Spending Outpaces Security," *National Underwriter Property and Casualty Edition*, Aug. 11, 2003, no page.

in the past."[17] With insurers' reserves looking up, the two years of steep insurance rate increases are also slowing. Aon Corp. reported that prices for U.S. commercial-property insurance "have begun to moderate, and in some cases, even fallen slightly."[18]

While the furvor surrounding terrorism and its impact on insurance companies waned, a series of natural disasters kept insurers on the alert. During August, the northeastern Unites States was affected by rolling blackouts which were estimated to cost insurers as much as $890 million.[19] Only one month later, the East Coast sustained $1.17 billion dollars in damage due to Hurricane Isabel.[20] While the East was being soaked, the California Coast was burning in record wildfires which destroyed 1,100 square miles and caused an estimated $2.5 billion dollars in damage.[21]

## Sarbanes-Oxley and accounting scandals

While 2003 did not see the big-dollar accounting scandals and bankruptcies of 2002, restatements of earnings continued at a blistering pace and new, smaller, scandals broke almost weekly. Among the most prominent scandals were Levi Strauss & Co. restatements, HealthSouth fraud, Sprint tax shelters, mutual fund company late-trading allegations, and charges of excessive compensation at the New York Stock Exchange.

During the first six months of 2003, 158 companies in the U.S. restated their earnings, according to Huron Consulting Group. In the second half of 2003, a record 195 companies restated their earnings.[22] Although the

[17] Chad Bray, "Reinsurers Have Battled Back From Post-Sept. 11 Uncertainty," *The Wall Street Journal*, July 23, 2003, B5B.

[18] Christopher Oster, "The Economy: Business-Insurance Costs Start to See Slower Rates of Increase," *The Wall Street Journal*, Apr. 7, 2003, A2.

[19] R.J. Lehmann, "Third-Quarter Cat Losses Up 300%, ISO Says," *Best Insurance News*, Oct. 13, 2002, 28.

[20] R.J. Lehmann, "Third-Quarter Cat Losses Up 300%, ISO Says," *Best Insurance News*, Oct. 13, 2002, 28.

[21] Business from Staff and News Services, The Press-Enterprise, Nov. 12, 2003, D2.

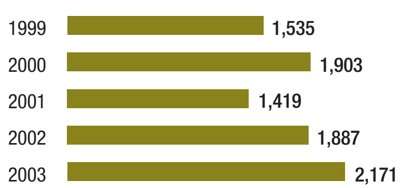
[22] Kath Kristof, "Restatements of Earnings Multiplying," *Chicago Tribune*, Oct. 19, 2003, 3.

numbers are frightening, some experts believe that the restatements are a healthy sign that the rules approved by the SEC under the Sarbanes-Oxley Act are taking affect.[23] The new corporate-governance rules were approved just before the January 26 deadline set by the SEC, even though at the time they were released, the oversight board remained leaderless.[24] (William Webster, the first chairman, stepped down when his involvement in a company under SEC scrutiny was made public.)

The new rules include provisions for better regulation of auditors and restrictions on what they can do. In particular, the rules bar auditors from doing most non-audit work for audit clients, although tax services are exempted. The rules also prevent SEC registrants from filing flawed annual statements. Fears that the Sarbanes-Oxley Act would lead to shortages of candidates to fill board seats, permanent economic damage, a flood of class-action lawsuits, and price-gouging by audit firms, have remained largely unfounded.[25] However, the new rules did have a direct effect on the issuance of 2002 financial statements – 2,171 requests for extensions on SEC filings were filed.[26]

### More reports postponed

Number of requests to delay 10-Ks and other filings between January 1 and August 1 of each year:




*Source:* "More Annual Reports Delayed," *USA Today*, Apr. 2, 2003, B1

[23] Kath Kristof, "Restatements of Earnings Multiplying," *Chicago Tribune*, Oct. 19, 2003, 3.

[24] "Setting the Rules; Corporate Governance," The Economist Global Agenda, The Economist.com, Jan. 29, 2003.

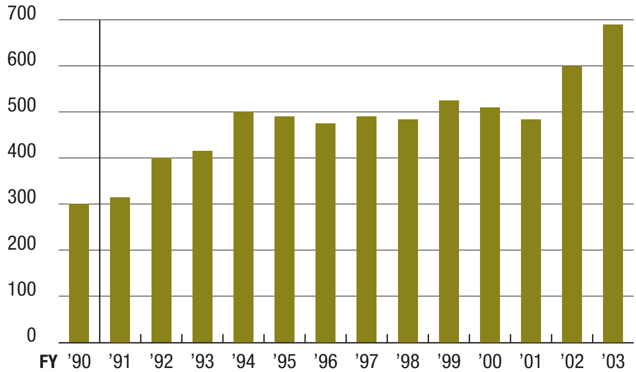
[25] Michael Schroeder, "Corporate Reform: The First Year," *The Wall Street Journal*, July 22, 2003, C1.

[26] Matt Krantz, "More Annual Reports Delayed," *USA Today*, Apr. 2, 2003, B1.

One rule that the SEC had under consideration turned out to be too little too late. The SEC had been considering the creation of a self-regulatory organization for mutual funds, similar to the National Association of Securities Dealers, but the measure was opposed by the mutual fund industry.[27] A scandal involving allegations of late trading and market timing broke in November, and rumors that the SEC failed for years to properly police the mutual fund industry, erupted soon thereafter.

### Mounting caseload

Total enforcement actions initiated by the Securities and Exchange Commission.




*Source:* "Behind SEC's Failings: Caution, Tight Budget, '90s Exuberance," *The Wall Street Journal*, Dec. 24, 2003, A1.

Baggage from the mutual fund scandal could have significant effects on the insurance industry. The Wall Street Journal notes, "The variable-annuity industry faces some clouds as the investigation into the mutual-fund trading scandal continues. While the allegations of trading abuses center mostly on regular mutual funds, regulators have seen the fingerprints of market timers in variable annuities, which work much like mutual funds [and are often managed by mutual fund firms]." Variable-annuity sellers

[27] "Setting the Rules; Corporate Governance," The Economist Global Agenda, The Economist.com, Jan. 29, 2003.

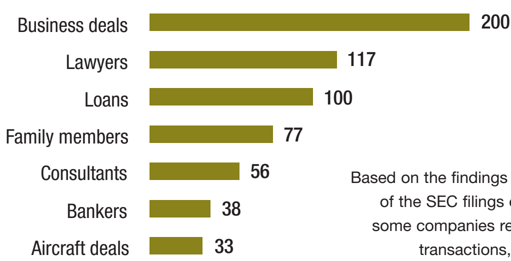
counter that they have long had rules against market timing and that contract provisions often make variable annuities much less attractive vehicles for timing activity than regular mutual funds.[28]

## Tax shelters

While the SEC attacked accounting scandals, the Department of the Treasury and the IRS put their energies into curbing tax shelter abuse. Final regulations relating to the listing, disclosure, and reporting of tax shelters were issued in February 2003. Additionally, Senate subcommittees held tax shelter hearings, a signal that tax shelters could be a hot topic in the election year.

### Close calls

Companies reporting related-party transactions involving:




Based on the findings of a Wall Street Journal survey of the SEC filings of 400 major companies. While some companies reported having no related-party transactions, others reported multiple ones.

*Source:* "Many Companies Report Transactions With Top Officers," The Wall Street Journal, Dec. 29, 2003, A1.

The final tax shelter regulations – which apply to all taxpayers, not merely those that engage in "abusive" transactions – are extremely intrusive, requiring disclosure of common business transactions. Given that Congress is likely to enact substantial monetary penalties and other sanctions for noncompliance with the disclosure requirements, which penalties are expected to apply to 2003 returns, companies are beginning

[28] Laura Saunders Egodigwe, "Quarterly Mutual Funds Review – Annuities Await Repercussions – Industry Sales Turn Up, But Providers Could Get Fallout From Fund Inquiry," *The Wall Street Journal*, Jan. 8, 2004, R25.

now to develop and implement compliance strategies and procedures. The IRS is cracking down not only through added regulations, but also through audits and examinations of suspected tax shelter promoters. Said Pamela Olson, Treasury assistant secretary for tax policy, "We've gone for a wider net."[29]

Tax shelters have been getting increased attention on the Hill. Democrats are using the fact that the final economic stimulus package contained none of the several dozen tax shelter abuse provisions in the Senate bill to attack Bush on his purported closeness to special interest groups. Taxpayers can expect to hear a clamor over tax shelter abuses during the 2004 election year, with Bush determined to prove that he is tough on abuses and Democrats arguing that he is not tough enough. Some presidential candidates started early: Senator John Kerry (D, MA) in June called Bush's tax shelter stance "a complete capitulation" to corporations.[30]

# Outlook for 2004

## Insurance industry

At the end of 2003 the industry remained divided as to a potential softening of the insurance market. While some coverages, including commercial property liability and personal auto insurance, saw stable or falling prices, the market was still hard in lines such as workers' compensation, medical malpractice, professional liability, and directors and officers liability.[31] The Insurance Services Office and National Association of Independent Insurers noted in a bi-annual report that "even with a 231.6 percent hike, the industry's first-half net income was still 2.5 percent lower than in the same period of 1999, and 22.5 percent below first-half 1997. Also, first-half surplus is 1.5 percent lower than it was at the end of 2000."[32]

[29] "Tax Shelter Rules Get Final Approval," *The Wall Street Journal*, Feb. 28, 2003, A2.

[30] John D. McKinnon and John Harwood, "Tax Shelters Come Under Fire – Democrats Push Crackdown, Hope to Cut Bush Approval Ratings," The Wall Street Journal, June 6, 2003, A4.

[31] Michael Ha, "Survey – This Insurance Marget Has Legs," *National Underwriter Property and Casualty Edition*, June 19, 2003, no page.

[32] "Industry Recovery Underway, But It's Far From Complete," *National Underwriter Property and Casualty Edition*, Oct. 1, 2003, no page.

Despite conflicting indicators across lines, it appears that the general trend is up. According to Fitch Ratings, the property/casualty insurance industry is projected to have improved underwriting results and profitability for 2004.[33] However, the market will not report an underwriting profit. Fitch also projects moderate growth in net written premiums, with higher growth in commercial lines than personal lines. In addition, Fitch projects diminished rates of price increases, as well as double-digit growth in policyholders' surplus.

Projections for the reinsurance sector include moderate premium growth, and lack of reserve development which will materially dampen earnings and capital formation in the intermediate term.[34]

### Back over 2000 for Nasdaq

Though it remains far from its record close above 5000, the Nasdaq Composite Index yesterday hit a milestone by closing above the 2000 level again. Below, the index and which stocks contributed most to its recent run.


#### Impact stocks

Since October 9, 2002, lowpoint.

| COMPANY | MARKET CHANGE CAP (in billions) | PERCENT IMPACT[1] |
|---|---|---|
| Intel | $122.2 | 9.48% |
| Cisco | 104.7 | 8.12 |
| Microsoft | 59.3 | 4.60 |
| Oracle | 26.8 | 2.08 |
| eBay | 24.4 | 1.89 |

[1] Percentage of the Nasdaq's 80% gain that this stock contributed

*Source:* "Nasdaq's Surge for the Year Hits 50%," *The Wall Street Journal*, Dec. 30, 2003, C1.

[33] Julie A. Burke, et.al., "Review and Outlook 2003-2004 Property/Casualty Insurance (North America)," FitchRatings, Dec. 16, 2003, 10.

[34] Julie A. Burke, et.al., "Review and Outlook 2003-2004 Property/Casualty Insurance (North America)," FitchRatings, Dec. 16, 2003, 10.

Further, Fitch believes that capital markets and interest rate levels will be important factors in life insurance company performance.[35] The most likely scenario is a moderate increase in interest rates, causing many life insurers to experience a moderation in spread compression and only a modest decline in the prices of fixed-rate investments. Furthermore, equity markets and credit defaults would not be expected to unduly strain insurer capital.

## Presidential campaign

As this publications goes to press, the 2004 presidential election is in full swing, with Democrats battling for the presidential nomination and President Bush striving to keep his 20 point lead in the polls.[36] In light of Bush's tax cut and tort reform pursuits—and the Democratic candidates' pursuit of corporate earnings—Bush is considered to be the favored candidate of business owners.

The "leading" Democratic contenders all include the elimination of tax shelters, corporate inversions, and corporate tax "subsidies" in their election platforms. Wesley Clark and John Edwards have both vowed to deny interest deductions for COLI on low-level employees.

With 14 of the 52 Democratic primaries and caucuses complete, Massachusetts Senator John Kerry leads the race for the Democratic presidential nomination. The primaries have affirmed Kerry's remarkable revival since the fall of 2003, when his prospects in New Hampshire seemed to sag while Howard Dean was soaring, and Kerry was forced to launch what appeared to be an improbable effort to revive himself in the fields and small towns of Iowa.[37] However, in Iowa Kerry upset Dean, winning the contest with 37 percent of the vote, while Dean finished third.

[35] Julie A. Burke, et.al., "Review and Outlook 2003-2004 North American Life Insurance," FitchRatings, Dec. 17, 2003, 2.

[36] Jeffrey M. Jones, "Bush Starts out Year with 60% Job Approval," Gallup News Service Online, Jan. 8, 2004.

[37] David S. Broder and Jim VandeHei, "For Party, Compass Points to Kerry," *The Washington Post*, Feb. 11, 2004, A1.

Kerry's landslide victories have pushed several candidates out of the race. Richard Gephardt's showing in the Iowa contest prompted him to bow out of the race early on. Senator Joseph Lieberman ended his run on February 3, following poor results in New Hampshire and Arizona. Retired general, Wesley Clark, quit the race after placing third in both the Virginia and Tennessee primaries.[38]

**AP Democratic Delegate Count February 2004**

Delegates needed to win: 2,162

Total Delegates: 4,322

| | |
|---|---|
| Sen. John F. Kerry | 507 |
| Howard Dean | 182 |
| Sen. John Edwards | 163 |
| Wesley Clark | 96 |
| Sen. Joseph I. Lieberman | 13 |
| Al Sharpton | 12 |
| Rep. Richard A. Gephardt | 4 |
| Rep. Dennis J. Kucinich | 2 |
| Other | 1 |

*Source:* A.P. Democratic Delegate Count, The Washington Post Online, Feb. 11, 2004.

Although polls show President Bush's current margin to be sizable, there are still many unknowns ahead. In order for President Bush to maintain his lead in the face of sharp criticism from Democrats, the economy must continue to improve, the U.S. must have continued success in Iraq and Afghanistan, and the homeland must remain safe from terrorism in all its forms. As there are many unknowns, taxpayers should follow candidates' platforms closely and analyze their proposals with respect to economic and tax policy for proper planning.

## Legislation

Election-year political considerations are expected to be a major factor in 2004 legislative prospects. The Bush Administration and Congressional GOP leaders want to build on a record of enacting significant tax cuts. At the same time, Congressional Democrats are expected to increase efforts to thwart the GOP's legislative priorities and push their own agenda.

For 2004, taxpayers can expect to see Congressional efforts to comply with the World Trade Organization rulings against the U.S. extraterritorial

[38] Mike Glover, "Clark to Withdraw from Presidential Race," *The Washington Post*, Feb. 11, 2004, no page.

income ("ETI") regime in an effort to avert European Union sanctions. Two ETI bills approved during 2003 are waiting for Congress to reconvene. March 1, 2004 is the cut-off date for Congress to approve the bills before the European Union imposes tarrifs on designated U.S. imports. Currently the bills focus more on protecting U.S. manufacturing jobs than reforming Subpart F.

Congress will also attempt to address energy tax legislation, extension of expiring tax provisions, pension legislation, and charitable giving incentives. The outlook for these bills remains unknown; however, a key factor in consideration of any tax legislation will be whether offsetting revenue raisers will be adopted in light of Senate demands that all tax legislation be revenue neutral. Revenue raisers included in the above proposals include tax shelter penalties, codification of economic substance, earnings stripping, executive compensation, and corporate inversion, among others.

## Budget outlook

As this publication goes to press, the Department of the Treasury has announced a series of legislative proposals included in the President's fiscal year 2005 budget which are designed to close loopholes, halt several "abusive" tax avoidance transactions, and simplify the tax code.[39] The Budget proposal reflects Bush's need to be seen as tough on tax shelters and would increase the total IRS budget by 4.8 percent to enhance compliance with the tax laws.

While most simplification proposals apply only to individuals, most of the IRS compliance and enforcement proposals apply to corporations. During 2004, the IRS proposes to **(1)** permit injunction actions against promoters who repeatedly disregard the registration and list-maintenance requirements, **(2)** curb abusive income-separation transactions, **(3)** prevent misuse of tax-exempt property and casualty insurance companies,

[39] "Treasury Announces New Budget Proposals," Department of the Treasury, Jan. 13, 2004.

and (4) prevent avoidance of U.S. tax on foreign earnings invested in U.S. property. These Treasury proposals, announced January 2004, go to lengths to take a tough stance against "abusive" tax avoidance transactions, as evidenced by the following quotes from top officials:

> ***"The laws must ensure that those who would shirk their civic responsibilities cannot do so by exploiting unintended loopholes, and the IRS must ensure that taxpayers do not engage in abusive tax avoidance transactions. Reducing the burden of government on citizens and the economy remains a critical part of the President's six point plan for jobs and economic growth."***
>
> Treasury Secretary John Snow.

> ***"We are committed to restoring confidence in the tax system by ending the proliferation of abusive tax avoidance transactions and simplifying the tax code."***
>
> Treasury Assistant Secretary for Tax Policy Pam Olson.

> ***"Curbing the use of abusive tax avoidance transactions by corporations and individuals is our top enforcement priority. Stiffer penalties for failing to comply with the rules on the promotion of abusive transactions will get the attention of promoters, attorneys, accountants and other advisors."***
>
> IRS Commissioner Mark W. Everson

Although most Congressional tax bills begin with the President's budget proposal, election-year politics make it difficult to predict the outcome of any tax legislation during 2004. Certainly Democrats and Republicans agree that outdated provisions in the U.S. tax code must be rectified, and even that abusive tax transactions should be curbed; however, taxpayers can expect that Democrats will fight the President's plans in order to put forward their own proposals in hopes of gaining the political momentum to carry them through the November elections. Whatever happens, it is certain that 2004 will be a year of campaigns, promises, winners, and losers.

2003 Tax legislation

# chapter 2

In January 2003 the Bush Administration released its FY 2004 budget proposals, which featured a 10-year, $1.4 trillion tax package with economic growth and tax simplification proposals. The Proposal set the stage for tax legislation during 2003. The Proposal included provisions to eliminate the double taxation of corporate dividends, make the 2001 tax cuts permanent, and extend several expiring tax provisions. In addition, the budget contained several revenue-raising provisions targeting tax shelters, executive compensation, and "earnings stripping" transactions. While the Administration pledged to work with Congress to address the Foreign Sales Corporation-Extraterritorial Income Exclusion (FSC-ETI) issue, the Proposal did not specifically address the issue or provide a timetable for action.

The President's proposal marked the first of many times during the year that taxpayers would see the introduction of revenue raisers aimed at offsetting the cost of various tax cuts. As budget deficit estimates ballooned, every major tax bill to pass through the House and the Senate included provisions to codify the economic substance doctrine, modify qualifications for tax-exempt property and casualty insurance companies, modify proration rules for life insurance business of property and casualty companies, address "inappropriate" nonqualified deferred compensation arrangements, strengthen regulation of tax shelter transactions, and tighten earnings stripping and inversion rules. Despite the consistency with which the provisions were added, at the end of 2003, none of them had become law.

Looming over the tax debate was the government's worsening fiscal fortune. House Budget Committee Democrats calculated that Bush's tax cut victory would push the 2003 deficit to a record $416 billion. Meanwhile, the White House sought a $984 billion increase in the government's borrowing limit to avert a default on its debt. However, at the close of 2003, Republicans argued that the tax cuts were having their desired effect, as employment and productivity rates were rising and the markets were rebounding.

> *The life insurance industry continues to take it on the chin in the nation's capital. Life insurers have suffered a series of defeats this year that affect how individual investors, corporate executives and companies use life-insurance products, such as annuities and split-dollar insurance arrangements. One factor is the budget deficit. Tax writers in Congress have to find offsetting corporate tax increases to pay for new tax cuts in pension, energy and international tax legislation. Congress is also tougher on corporate-governance issues in the wake of the Enron scandal.*
>
> Rob Wells, Tax Report: *Tax Wins Become Rare for Insurers*,
> The Wall Street Journal, Oct. 2, 2003, at D2.

# Enacted legislation

## 2003 Tax bill

### *Jobs and growth tax relief reconciliation act of 2003 - H.R. 2*

President Bush's budget proposals figured significantly into the tax package passed mid-year by the Senate and House of Representatives. The $350 billion compromise tax cut package was hailed by supporters as the third-largest tax reduction in history and the key to boosting the economy. While the total package was considerably smaller than what Bush and the House wanted—and considerably different from the President's original plan—Bush hailed it, saying: "[I]t is good for American workers, it is good for American families, it is good for American investors and it's good for American entrepreneurs."

The compromise agreement contained **NONE** of the numerous revenue raising tax provisions that were included in the Senate bill, but it did provide dividend and capital gains relief, expanded "bonus" depreciation and small business expensing, and changes to corporate estimated tax provisions. Most of the provisions, including the much-touted dividend taxation relief, affect individuals only. The hope was that the cuts, coupled with temporary breaks for businesses that buy new equipment, would spur investments and create jobs.

**Dividends and capital gains relief**

The bill reduced the 10- and 20-percent rates on net capital gains to five (zero, in 2008) and 15 percent, respectively, effective for sales and exchanges on or after May 6, 2003, and before January 1, 2009. Dividends received by *individuals* from domestic and qualified foreign corporations are taxed at the same rates that apply to capital gains, effective for dividends received in tax years beginning after 2002 and before 2009.

*Although in an effort to build support for its dividend-tax-cut proposal, the Bush administration said it would seek a way to reduce the plan's impact on the insurance industry, and particularly on people who buy its annuities, the final bill left out the resolution of the annuity problem. Annuity plans offer tax-free buildup of investments, but payouts typically are taxable at ordinary-income rates. With the switch to tax-free dividends, annuities could lose appeal, because dividends received outside such plans could be taxed less. The industry lobbied Treasury after the bill was passed, but no changes were made.*

See John D. McKinnon, *Annuities Could Get a Tax Break in Horse Trading Over Dividends*, The Wall Street Journal, Mar. 6, 2003, at D2.

### Bonus depreciation and small business expensing

The bill allowed an additional first-year deduction equal to 50 percent of the adjusted basis of qualified property, effective for property acquired after May 5, 2003, and before January 1, 2005, and placed in service before January 1, 2005, with certain exceptions. Qualified property includes MACRS property with a recovery period of 20 years or less, water utility property, computer software not covered by section 197, and qualified leasehold improvement property. The bill also increased the section 179 expensing amount for small businesses to $100,000 for property placed in service in taxable years beginning in 2003 through 2005.

### Corporate estimated tax payments

The bill provided that, for corporate estimated tax payments due on September 15, 2003, 25 percent was not required to be paid until October 1, 2003. The provision was intended to shift tax revenues from the federal government's current fiscal year to the next fiscal year, which began October 1.

### Temporary tax breaks

Many of the tax breaks passed in the bill could be temporary. In effect, Republicans squeezed at least $800 billion in tax cuts through 2013 into the $350 billion price tag that could pass the Senate, but only by resorting to some complex accounting. For example, the child credit would jump to $1,000, then fall to $700 in 2005, rise to $800 in 2009, return to $1,000 in 2010, then plunge to $500 in 2011.

No other significant tax legislation was passed despite the numerous proposals.

# Noteworthy legislation not enacted

## Estate tax repeal

### *Death tax repeal permanency act of 2003 – H.R. 8*

The House of Representatives approved 264 to 163 H.R. 8, the Death Tax Repeal Permanency Act of 2003, which would do away with the sunset provision of the estate tax repeal in President Bush's 2001 tax act.

House Republicans began pressing for permanent repeal of the estate tax shortly after Bush signed EGTRRA. But a similar repeal (also H.R. 8) with a smaller cost fell short of the necessary votes for Senate passage in June 2002. This bill also failed to achieve the Senate vote.

> *The House of Representatives approved permanent repeal of the estate tax, but the legislation is not expected to pass the Senate. The increasing budget deficits combined with a variety of other priorities indicates that the Senate will not vote in favor of permanent repeal. Longer term, some believe the trend is toward permanent reform, rather than repeal.*
>
> Steven Brostoff, *House Passes Repeal of Estate Tax – Outlook Dim For Senate Approval*, National Underwriter, Jun. 19, 2003, no page.

## ETI bills

### *The american jobs creation act of 2003 – H.R. 2896 and The jumpstart our business strength act – S. 1637*

The Senate Finance Committee and the House Ways and Means Committee separately considered and approved economic growth packages which included several proposals that would directly affect insurance companies. The bills included international and other corporate tax reforms and a host of revenue raisers such as proposals limiting the section 501(c)(15) exemption for certain property and casualty companies, applying life insurance proration rules to the life insurance reserves of property and casualty companies, taxing inverted companies as domestic, and clarifying the rules of section 845.

**Section 501(c)(15)**

A property and casualty insurance company would be eligible to be exempt from Federal income tax if its gross receipts for the taxable year do not exceed $600,000, one half of which must be derived from premiums (rather than investment income).

In addition, the bill would have amended section 831 to allow non-life insurance companies whose net written premiums (or if greater, direct written premiums) for the taxable year do not exceed $1,200,000 ($1,890,000 in the House bill) to be taxed only on their investment income. Currently the statute allows companies to be taxed only on investment income if their net written premiums (or if greater, direct written premiums) for the taxable year exceed $350,000 but do not exceed $1,200,000.The proposal retains the present-law rule that, for purposes of determining the amount of a company's net written premiums or direct written premiums under section 831, premiums received by all members of a controlled group of corporations of which the company is a part are taken into account.

Industry trade associations lobbied for an increase of the thresholds for 501(c)(15) companies to $1,890,000, but were successful only in the House. They were also successful in having the thresholds indexed for inflation in the House bill.

**Proration rules**

Life insurance company proration rules, rather than the property and casualty insurance proration rules, would apply with respect to life insurance reserves of a property and casualty company.

### Inverted corporations and section 845

The Senate proposal incorporated provisions of previously introduced bills including provisions requiring that **(1)** transactions involving at least 80 percent stock ownership would be considered pure inversion transactions and taxed as domestic corporations and **(2)** transactions involving greater than 50 percent but less than 80 percent stock ownership would be considered limited inversion transactions. Limited inversion transactions would be respected, but any applicable corporate-level "toll charges" for establishing the structure may not be offset by tax attributes, and the IRS is given expanded authority to monitor related-party transactions including section 163(j) "earnings stripping" rules.

The proposal would also authorize the IRS to use section 845 to allocate and recharacterize income in a manner similar to the authority under section 482 for related party transactions and to issue regulations under section 845(a).

To become law, the proposals must be passed by the Senate and House and agreed to in Conference. Because of campaigning, a full legislative agenda, and disagreements between Republicans and Democrats, the two bills were not voted on during 2003. The issues are expected to be revisited early in 2004.

> *Revenue-raising provisions in the tax cut reconciliation bill on the Senate floor drew criticism May 14. The American Institute of Certified Public Accountants May 14 wrote to Senate Finance Committee Chairman Charles Grassley (R-Iowa) and ranking member Max Baucus (D-Mont.) warning that certain changes "will result in double taxation, lost American jobs, and increased tax complexity."*
>
> *Tax Legislation Revenue-Raising Provisions of Senate's Tax Bill Criticized*, BNA Daily Tax Report, May 15, 2003, at G-13.

## Care act–S. 476

The CARE Act was the third bill that the Senate Finance Committee cleared with significant revenue raisers. The charity bill, S. 476, The CARE Act of 2003, contained tax shelter and individual expatriation provisions, including codification of the "economic substance" doctrine and requiring corporate CEOs to sign their company's federal tax returns.

The committee approved several other provisions to curtail tax shelters, including an additional $300 million for IRS tax law enforcement. The measures would:

(1) increase the penalties on failures to disclose reportable transactions;

(2) modify accuracy-related penalties for listed and reportable transactions with a significant tax avoidance purpose;

(3) modify the substantial understatement penalty;

(4) impose a civil penalty on failure to report interest in foreign financial accounts; and

(5) amend section 163 to disallow a deduction for deficiency interest paid to the IRS on underpayments involving tax-motivated transactions.

Sen. Baucus said requiring CEOs to sign company tax returns would be consistent with a provision requiring CEO certification of financial statements enacted as part of the Sarbanes-Oxley Act.

## COLI

### *Life insurance employee notification act – H.R. 414*

Rep. Gene Green (D, TX) introduced H.R. 414 which would have deemed the nondisclosure of employer-owned life insurance coverage of employees an unfair trade practice under the Federal Trade Commission Act.

The bill, cited as the "Life Insurance Employee Notification Act," would have required the employer to provide written notice no later than 30 days after the date on which the employer-owned insurance policy is purchased, to each employee for whom the employer carries a policy.

The bill was similar to H.R. 4551, which Rep. Green introduced in July 2002. It was referred to the Committee on Education and the Workforce, and to the Committee on Energy and Commerce but received no further action.

Although no legislation affecting COLI was passed, the Senate held a COLI hearing in mid-October during which Gregory F. Jenner, Treasury deputy assistant secretary for tax policy, discussed the valid uses of corporate owned life insurance, identified where problems exist, and suggested how the problems should be addressed. The hearing appeared to be favorable for insurers. In addition to Treasury officials, industry representatives and members of Congress also testified to the benefits of COLI. Senator Kent Conrad (D, ND) stated, "This committee's markup of the pension bill last month all but shut down the COLI market. The committee's actions were intended to address concerns that some of my colleagues here have about COLI. But, no matter where my colleagues stand on COLI, I think we can all agree that shutting down the COLI market was not our intention."[40]

## Inversions

### *Omnibus appropriations resolution - HJRes 2*

While the issue was overshadowed by corporate accounting scandals in the press, inversions were still a hot legislative topic during 2003. The House and Senate passed a provision tightening the prohibition on Department of Homeland Security contracts with "corporate expatriates" in the omnibus FY03 appropriations bill. The provision limits the authority

[40] See "Unofficial Transcript Records Finance Committee's Examination of COLI Proposals," Tax Analysts, 2003 TNT 211-35.

of the Secretary of the Department to waive the prohibition. It restricts the waiver authority to contracts which the Secretary determines are required in the interest of homeland security; the current law gives the Secretary waiver authority for economic reasons (job loss and additional government cost).

### *Corporate patriot enforcement act – S. 2520*

Senate Finance Committee member Harry Reid (D, NV) and Sen. Carl Levin, (D, MI) reintroduced the Corporate Patriot Enforcement Act, which would make it more difficult for U.S.- based companies that relocate abroad to avoid paying U.S. income taxes. The Act would amend the current definition of "domestic" corporation and add a new section to provide that in corporate expatriation transactions, certain corporations will be treated as domestic corporations.

### *Corporate patriot enforcement act of 2003 – H.R. 737*

House Ways and Means Committee member Richard Neal (D, MA) introduced H.R. 737, the "Corporate Patriot Enforcement Act of 2003," which would amend the Internal Revenue Code to prevent corporations from avoiding the U.S. income tax by reincorporating to a foreign country.

Representative Neal introduced a similar bill in 2002.
Neither bill came to a vote.

### *The energy policy act of 2003 – H.R. 6 and energy tax incentives act of 2003 – S. 1149*

At year-end Congress was still attempting to reconcile differences in House- and Senate-passed versions of energy legislation featuring both tax and non-tax provisions intended to promote energy production, supply, efficiency, and conservation. Both bills contained anti-inversion provisions, and the Senate bill contained reinsurance provisions under section 845(a).

### *Invest in the U.S.A. act – S. 596 and Homeland investment act of 2003 – H.R. 767*

Senator Ensign (R, NV) and Representative English (R, PA) introduced S. 596 and H.R. 767 to encourage investment of foreign earnings in the United States. The bills would have amended Subpart F to tax electing taxpayers on **(1)** the excess qualified foreign distribution amount, and **(2)** the amount determined under section 78 that is attributable to such excess qualified foreign distribution amount. As a temporary replacement of the current 35-percent rate, the bills would effectively impose, for one year, a 5.25-percent toll tax on dividends in excess of normal distributions from foreign subsidiaries.

> *Testifying at the Senate Finance Committee's hearing on international competitiveness, a representative from Dow Chemical said, "In order to allow companies like mine to continue playing a vital role in increasing U.S. exports and maintaining millions of American jobs, repeal of the ETI provision must be coupled with much needed reforms of our outmoded international tax laws. Congress should strive to maintain the competitiveness of all American businesses and their workers, without discriminating against U.S. companies that have substantial, active businesses abroad."*
>
> *Dow Chemical Testifies at Finance Committee's Second Hearing on International Competitiveness*, Tax Notes Today, Jul. 15, 2003, 136-34.

Under the bills, the excess qualified foreign distribution amount is the excess of dividends received by the taxpayer from controlled foreign corporations in which the taxpayer is a United States shareholder, over the average amount of dividends received during the last three years from controlled foreign corporations in which the taxpayer is a United States shareholder on the date such dividends are paid.

Proponents of the bill said that it would drain money from offshore tax-havens and improve the failing U.S. economy. Industry analysis suggested that the bill would bring between $150-200 billion back onshore. The bill came in the wake of several other bills which were proposed to tax inverting companies as domestics.

## Life insurance simplification

### *The life insurance simplification tax act of 2003 – H.R. 808*

House Ways and Means Committee member, Amo Houghton (R, NY), introduced a bill to repeal the section 809 differential earnings adjustment on policyholder dividends of mutual life insurance companies and the section 815 income inclusion from policyholder surplus accounts when a triggering event occurs.

The bill was identical to the Life Insurance Simplification Acts of 2000, 2001, and 2002. Although the Bush Administration's FY 2004 proposal included the permanent repeal of section 809, this bill did not fare any better than its predecessors.

### *The life insurance simplification act of 2003 – S. 992*

Senator Don Nickles (R, OK) and Senator Kent Conrad (D, ND) introduced the Life Insurance Simplification Act of 2003 that would have repealed the section 809 differential earnings adjustment on policyholder dividends of mutual life insurance companies and the section 815 income inclusion from policyholder surplus accounts when a triggering event occurs.

The bill was identical to the Life Insurance Simplification Act of 2003 introduced in the House by Rep. Houghton in February and the Life Insurance Simplification Acts of 2000, 2001, and 2002.

## Self employment exemption

### *Former insurance agents tax equity act of 2003 – H.R. 1250*

Representative Paul Ryan (R, WI) introduced H.R. 1250, Former Insurance Agents Tax Equity Act of 2003. The bill would have modified the exemption from the self-employment tax for certain termination payments received by former insurance sales agents to exempt them from the self-employment tax.

Similar bills have been introduced in the past. None have come to a vote.

## Exempt property & casualty companies

### *The small insurance company inflation adjustment act – S. 735*

Senator Christopher Bond (R, MO) introduced S. 735, The Small Insurance Company Inflation Adjustment Act, which would clarify the exemption from tax for small P&C insurance companies by adjusting the exemption to reflect inflation. The exemption has existed since 1942 but has not been adjusted since 1986.

Following negative press reports regarding tax-exempt insurance companies used to shield investment profits from taxes, several amendments were introduced to make significant changes to the P&C exemption. As a result of this press, this bill was never considered. Identical bills, S. 2084 and H.R. 1908, were introduced in 2001 and 2002.

## Consolidated NOLs

### *Bill to permit the consolidation of life insurance companies with other companies – H.R. 2228 and S. 1495*

Philip M. Crane (R, IL) introduced H.R. 2228 and Senators Jim Bunning (R, KY) and Kent Conrad (D, ND), introduced S. 1495, both of which would have allowed life insurance companies to consolidate with other companies.

The bills would have stricken the portions of section 1504 which relate to the five-year wait to include life insurance companies in an affiliated group and section 1503(c), which allows 35 percent of the non-life loss or the life insurance company taxable income, whichever is less, to be taken into account in determining the consolidated taxable income of the affiliated group. The bills would have replaced the 35 percent rule in section 1503(c) with a provision to "phase-in" the offset of non-life losses against life insurance company income over a five year period.

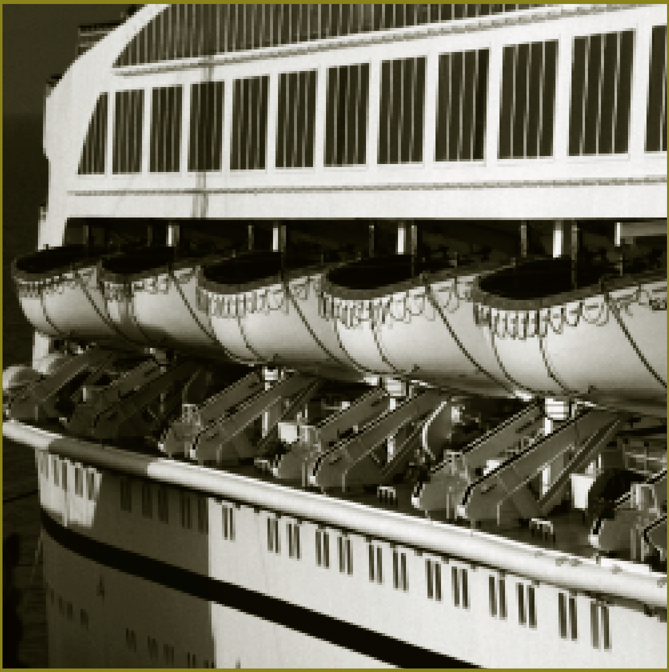
Bills calling for life/non-life consolidation have been introduced in past legislative sessions, but have never come to a vote.

## Overview

In general, the 2003 legislative developments were much the same as legislation enacted or introduced during 2002. The 2003 tax bill built largely on tax cuts passed in the 2002 economic stimulus bill. Likewise, inversion bills introduced in 2003 mirrored those introduced in 2002. The same was true with life insurance simplification, life/non-life consolidation, exempt property and casualty insurance companies, and COLI.

Election-year politics will be a major factor in the prospects for tax legislation in 2004. Items expected to be at the top of the legislative agenda for 2004 include repeal of the FSC/ETI regime and an election-year budget resolution.

# Reserves



chapter 3

As the market showed signs of softening, several insurers increased reserves. A study by Weiss Ratings Inc. found that U.S. property-casualty insurers increased reserves for prior-year claims by $22.1 billion in the last year. The study noted that the industry had already raised reserves by $11.7 billion in 2001.[41]

While observers generally agree that the property and casualty industry is overcapitalized, many believe that current reported capital levels do not reflect inherent reserve inadequacies. If so, continued rate pressure could eventually leave many insurers in financial peril. In this environment, financial strength may serve as a competitive advantage, although continued financial, actuarial and management attention will be needed to maintain that strength.

On the administrative side, there was little development in the area of reserves during 2003. The Treasury finalized regulations that it proposed during 2002 and released the annual prevailing state assumed rates, in addition to announcing new actuarial software. Also issued were a Revenue Ruling clarifying the amount of reserves used to calculate required interest, a Technical Advice Memorandum relating to the use of AG 33, and two rulings regarding the tax consequences of transferring assets held in retired health reserves to VEBAs.

[41] *Industry Reserves Adjusted $22 B in '02* – Weiss, National Underwriter, Jul. 9, 2003, no page.

## Final regulations under section 817A

The IRS released final regulations defining the appropriate interest rate to be used in the determination of tax reserves and required interest for certain modified guaranteed contracts.[42] The final regulations also addressed how temporary guarantee periods that extend past the end of a taxable year are to be taken into account. The final regulations replaced proposed regulations released June 3, 2002.

The final regulations define the current market rate for non-equity-indexed MGCs, but not for equity-indexed MGCs.

In response to comments on the proposed rules regarding how temporary guarantee periods that extend past the end of a tax year are accounted for, the final regulations waive the reserve computation rules of Section 811(d) throughout the guarantee periods of non-equity-indexed MGCs.

The final regulations generally are effective on May 7, 2003. However, pursuant to Section 7805(b)(7), taxpayers may elect to apply the rules retroactively for all taxable years beginning after December 31, 1995, the effective date of Section 817A.

*Cochran, Caronia & Company, an investment banking firm that specializes in the insurance industry, released a study concluding that intense pressure for higher reserves will force weaker commercial insurers to become more aggressive in obtaining a larger part of market share and may soften the competitive environment. A managing director at the firm noted that "The current hard market will help underwriting profitability and should give insurers more flexibility and cushion the blow in dealing with past reserve problems."*

Gary Mogel, *Commercial P-C Reserves Could be $20 Billion Deficient, Study Says*, National Underwriter, Jun. 19, 2003, no page.

[42] 68 Fed. Reg. 24349-24351 (May 7, 2003).

## Prevailing state assumed and applicable federal interest rates – Rev. Rul. 2003-24[43]

The IRS released prevailing state assumed and applicable federal interest rates (AFR) for tax years beginning after December 31, 2001, supplementing Rev. Rul. 92-19.[44] Revenue Ruling 2003-24 provides new rates for calculating the reserves for life insurance and supplementary total and permanent disability benefits, individual annuities and pure endowments, and group annuities and pure endowments. Under Section 807(d)(2)(B), the interest rate to compute reserves must be the greater of the AFR or the prevailing state assumed interest rate. Therefore, the applicable federal rates are also supplemented.

### Applicable federal interest rates

| YEAR | INTEREST RATE |
|---|---|
| 2002 | 5.71 |
| 2003 | 5.27 |

### Prevailing state assumed interest rates

A. *Life insurance valuation:*

| GUARANTEE DURATION (YEARS) | CALENDAR YEAR OF ISSUE (2003) |
|---|---|
| 10 or Fewer | 5.00 |
| 11-20 | 4.75 |
| 21 or More | 4.50 |

As the applicable federal rate for 2003 of 5.27 percent exceeds this prevailing state assumed rate, the interest rate to be used for this product under Section 807 is 5.27 percent.

[43] Rev. Rul. 2003-24, 2003-10. I.R.B. 1.

[44] Rev. Rul. 92-19, 1992-13, I.R.B. 4.

B. *Single premium immediate annuities and annuity benefits involving life contingencies arising from other annuities with cash settlement options and from guaranteed interest contracts with cash settlement options:*

| CALENDAR YEAR OF ISSUE | VALUATION INTEREST RATE |
|---|---|
| 2003 | 6.50 |

As the prevailing state assumed rate exceeds the applicable federal rate for 2002 of 5.71 percent, the valuation interest rate of 6.50 percent is to be used for this product under Section 807.

C. *Other annuities and guaranteed interest contracts valued on an issue year basis:*

Since the state rate varies from 4.5% to 6.5%, in some cases the federal rate should be used, while in others the state rate should be used.

## 2003 discount factors - Rev. Proc. 2004-9[45] and Rev. Proc. 2004-10[46]

The IRS released two Revenue Procedures prescribing the loss payment patterns and discount factors and the salvage discount factors for the 2003 accident year. These factors are for use in computing discounted unpaid losses and estimated salvage recoverable under Sections 832 and 846 of the Internal Revenue Code. These Revenue Procedures now include composite discount factors, as promised in Revenue Procedure 2002-74.[47]

## Required interest – Rev. Rul. 2003-120[48]

The IRS clarified the amount of reserves used to calculate “required interest” under section 812(b)(2)(A).

[45] Rev. Proc. 2004-9, 2004-2, I.R.B. 1.

[46] Rev. Proc. 2004-10, 2004-2, I.R.B. 1.

[47] Rev. Proc. 2002-51, I.R.B. 980.

[48] Rev. Rul. 2003-120 2003-48, I.R.B. 1154.

Life insurance companies compute the amount of the section 807(c)(1) life insurance reserves under section 807(d)(2), using the greater of the applicable Federal interest rate or the prevailing State assumed rate. If neither the prevailing State assumed interest rate nor the applicable Federal interest rate is used, required interest is calculated using “another appropriate interest rate.” Although required interest is a significant component of policy interest, section 812(b)(2) provides no guidance (other than the interest rates) regarding the method of calculating required interest. The Rev. Rul. provides that guidance.

Under the Rev. Rul., required interest under section 812(b)(2)(A) equals the sum of products obtained by multiplying (a) the mean of the beginning-of-year and end-of-year reserves under section 807(c)(1)-(6) (other than section 807(c)(2)) by (b) the applicable interest rate (the prevailing State assumed interest rate, the applicable Federal interest rate, or another appropriate interest rate).

## AG 33 – TAM 200328006[49]

Taxpayer is a life insurance company which issues Annuities. Before AG 33 was enacted, Taxpayer held constant interest rates throughout the deferred period of its policies. After AG 33 was enacted, Taxpayer began using different valuation interest rates when different assumed annuitization dates affected the estimated duration. In addition, Taxpayer began to consider partial annuitization and withdrawal scenarios in the calculation of the greatest present value of future benefits. Taxpayer’s reserve strengthening represented the company’s application of the changes necessary to comply with the guidance provided in AG 33, and the changes were applied for both statutory accounting and tax accounting purposes.

The IRS concluded that, because AG 33 was not in effect on the date of issuance of the Annuities, Taxpayer may not use AG 33 in determining the tax reserves for those Annuities.

[49] Technical Advice Memorandum 200328006 (Mar. 20, 2003).

> *The Combined ratio after dividends for 2001 moved up from 110.1 in 2000 to 115.9 in 2001, a deterioration of 5.8 percentage points.*
>
> Insurance Information Institute, Property Casualty Fact Book 2003, 20.

## New software

IRS officials announced new actuarial software the IRS will use to analyze life insurance companies' tax reserves.

According to the IRS, the software program, called Total Life, will allow them to stop using outside actuaries. Currently, the IRS has only two actuaries on staff and has been contracting with outside actuary firms to determine whether a company has properly calculated its tax reserves.

The program reportedly can compute statutory and tax reserves for every product issued by a life insurer. The IRS has reported that it will use the program to reproduce the company's statutory reserves and to calculate the proper tax reserves to compare with the company's reserves. Due to limitations in the program's capabilities, it will not initially be used to test failures in sections 7702 and 7702A.

Because taxpayers and the IRS are often at odds over the proper way to calculate tax reserves, it seems unlikely that any one program will resolve these conflicts.

## Health reserves – PLR 200327063[50] and PLR 200327066[51]

PLR 200327063 and PLR 200327066 are two substantially identical rulings regarding the tax consequences of two Companies' proposed transfers of assets held in retired health reserves to voluntary employees' beneficiary associations (VEBAs).

[50] PLR 200327063 (July 3, 2003).

[51] PLR 200327066 (July 3, 2003).

The companies in both rulings are life insurance companies that maintain group health plans for their active and retired employees. Under the Policies, both Companies maintain Reserve, a welfare benefit fund under section 419(e), to provide post-retirement medical benefits for eligible retirees. The Companies also maintain two VEBAs, Trust A and Trust B, which provide funding for post-retirement medical benefits, and certain other benefits.

In order to simplify the administration of the Health Plans and provide greater flexibility, Companies propose to transfer up to all of the amounts held in the Reserve for nonrepresented retirees to Trust A and up to all of the amounts held in the Reserve for represented retirees to Trust B.

The IRS found that the Reserves in both rulings are retired lives reserves maintained to provide post-retirement medical benefits to eligible retirees. As such, the Companies have the right to have the amounts in the Reserves applied against future years' benefit costs or insurance premiums. Further, the transfer of a retired lives reserve subject to sections 419 and 419A to a VEBA does not result in a reversion to the employer, or cause the VEBA to lose its tax-exempt status. Accordingly, the IRS ruled that transfer of amounts from the Reserve to the Trusts should not give rise to taxable income.

# Captive insurance companies

chapter 4

Despite a softening market, with insurance costs still high, the number of companies looking to captive insurance arrangements had not slowed, and the IRS continued to investigate captive arrangements and challenge them on their substance. One such challenge was issued during 2003 in the form of a TAM. During the year, UPS also announced that it had settled several suits in which it had challenged allocations made by the IRS for the company's reinsurance income.

Another area of challenge in 2003 continued to be the tax shelter listing requirements of Notice 2002-70[52] which identified as a listed transaction certain arrangements used by taxpayers to shift income to related companies purported to be insurance companies that are subject to little or no U.S. federal income tax.

[52] Notice 2002-70, 2002-44 I.R.B. 765.

## Captive arrangement challenged – TAM 200323026[53]

The IRS held that amounts paid by a parent and its subsidiaries to a *related* captive insurance company for pollution liability coverage are not deductible insurance premiums under section 162. The IRS also ruled that the amounts paid by the parent and its subsidiaries for workers' compensation coverage to an *unrelated* insurance company, which in turn reinsured the risks with a related foreign captive insurance company, are not deductible insurance premiums.

> *Speaking informally at a conference in Washington June 20, IRS representatives commented on the relevance of capitalization, risk shifting, and the presence of actual loss in determining what is insurance for tax purposes. During the conference, the IRS noted that one of the more "glaring" factors in TAM 200323026 was the undercapitalization of the purported insurance carrier. Further, it was noted that the government typically is interested in seeing if there is enough capital to insure the risk that a company is underwriting.*
>
> Christine J. Harris, *IRS Reps Comment on Insurance Criteria for Captive Arrangements*, Tax Notes Today, Jun. 20, 2003, 120-2.

Parent, a holding company whose operating subsidiaries are engaged in various manufacturing businesses in the U.S., is owned by Foreign Parent. Foreign Parent formed Insurance Subsidiary with a capitalization substantially lower than that suggested by its advisors. Foreign Parent then issued a letter of financial support to Insurance Subsidiary. Parent and its subsidiaries deducted amounts paid to Insurance Subsidiary as insurance premiums under section 162.

[53] TAM 2003 23026 (6 Jun. 2003).

The IRS held that the arrangements did not constitute insurance for federal income tax purposes, and that amounts paid were not deductible as insurance premiums. The IRS noted several factors in its decision including inadequate capitalization, informality between the parties, parental guarantees, and limited risk distribution.

## UPS settles suits

In a release of their 2002 fourth quarter results, United Parcel Service reported that it settled several suits in which it had challenged allocations made by the IRS for the company's reinsurance income.

One of the settlements was related to the 2001 Eleventh Circuit Court of Appeals decision that remanded the case to the Tax Court to find whether the IRS's determination of deficiencies could be upheld under Sections 482 or 845(a). The Appeals Court had previously overturned the Tax Court opinion, holding that UPS's plan had both an economic effect and a business purpose.

*IRS representatives continued to invite insurance representatives to send in their ruling requests now that via Rev. Proc. 2002-75, the IRS has removed the "captive issue" from its No Rule List. The Revenue Procedure, issued late in 2002, eliminates certain provisions of Rev. Proc. 2002-3 that indicated the IRS would not consider whether risk shifting and risk distribution were present with respect to the qualification of a company as an insurance company or to the deductibility of taxpayer "insurance" premium payments.*

See Christine J. Harris, *IRS Reps Comment on Insurance Criteria for Captive Arrangements*, Tax Notes Today, Jun. 20, 2003, 120-2.

Although this case struck a significant blow to the IRS, it is still unclear whether the Appeals Court's reasoning will be followed in other circuits. Additionally, IRS Deputy Associate Chief Counsel (International) Steven Musher said at the American Bar Association's midyear meeting that the IRS "will continue in appropriate cases to assert Sections 482 and 845(a) to determine allocations from related parties" when shifting of insurance-related income offshore is involved.

## Producer-owned reinsurance companies

Notice 2002-70 made transactions with certain unrelated insurance companies listed transactions, meaning that taxpayers may be required to disclose the transactions to the IRS. Likewise, under list maintenance rules, taxpayers are required to keep lists of clients who have implemented with the taxpayer's assistance listed or substantially similar transactions and with respect to which the taxpayer was a "material advisor."

Many insurance companies participate in accordance with Notice 2002-70 in the operation of an unrelated insurance company through reinsurance, and as a result, may be a material advisor under the regulations. Taxpayers should be aware of their responsibility to maintain lists of potentially abusive tax shelters for which they have been material advisors, including "producer-owned reinsurance companies." Further, companies that sell and reinsure insurance products should ensure that pricing is arms-length and that the structure and operations of the captive comport with insurance industry practices.

# Tax shelters

chapter 5

Tax shelters continued to be at the forefront of the legislative and regulatory agendas during 2003. Disappointed by the outcome of previous attempts to gain information on tax shelters, the IRS finalized exacting tax shelter regulations during the year and further refined its process of requesting tax accrual workpapers.

In addition to Enron, the names of several prominent public companies such as Tyco, WorldCom, Levi Strauss, among others have appeared frequently in the news for purported abuses, with alleged tax shelter activity often part of the picture. Since the beginning of 2002, the IRS has completed 207 tax shelter examinations, and more than 3,850 were either in progress or scheduled as of July 2003.[54] That number is sure to increase with the finalization of tax shelter regulations and the continuing issuance of listed transactions.

[54] Sheryl Stratton, *Inside OTSA: A Bird's-Eye View of Shelter Central at the IRS*, Tax Notes Today, Sept. 5, 2003, 174-2.

## Final tax shelter regulations

The IRS issued final regulations relating to the filing of disclosure statements under section 6011(a), the registration of corporate tax shelters under section 6111(d), and the list maintenance requirements under section 6112.[55] Under the final regulations, taxpayers are required to disclose "reportable transactions." Reportable transactions include:

1. Listed transactions
2. Confidential transactions
3. Contractual protection transactions
4. Certain loss transactions
5. Book-tax difference transactions
6. Brief asset holding period transactions.

Of these reportable transactions, only listed transactions have been identified as abusive transactions. Rev. Proc. 2003-24[56] providing exceptions to the loss transaction factor and Rev. Proc. 2003-25[57] providing exceptions to the book-tax difference factor were issued with the regulations.

Key changes in the final regulations included:

**Application:**

The temporary and proposed regulations applied to reporting companies under the Securities Exchange Act of 1934 and to entities with $100 million or more in gross assets. The final regulations apply to all taxpayers except the book-tax difference factor which applies only to SEC registrants and companies with gross assets greater than $250 million. The requirement for disclosure of book-tax differences of $10 million on a gross basis remains unchanged.

[55] 68 Fed. Reg. 10161-10178, (Mar. 3, 2003).

[56] Rev. Proc. 2003-24, 2003-11, I.R.B. 1.

[57] Rev. Proc. 2003-25, 2003-11, I.R.B. 1.

**Disclosure requirements:**

For purposes of both Sections 6011 and 6111, the definition of a confidential transaction no longer includes the clarification that a privilege held by the taxpayer does not cause a transaction to be confidential. Explanatory comments issued with the regulations confirm that the attorney-client privilege does not affect whether a transaction is confidential.

The focus of the contractual protection factor is now whether fees are refundable or contingent.

*During the final days of 2003, the IRS released revised final regulations under Section 6011[58] which provide that the disclosure of confidential transactions on a return is limited to transactions for which an advisor has imposed confidentiality on a taxpayer to protect the advisor's tax strategies from disclosure, and the taxpayer directly or indirectly pays the advisor a minimum fee. The revisions are intended to reduce unnecessary disclosures for taxpayers and advisors and to allow the IRS to focus its attention on transactions with potential for abusive tax avoidance, not on transactions for which confidentiality is required for non-tax reasons.*

The book-tax difference factor has been revised to provide that if a taxpayer in the ordinary course of its business keeps books on a basis other than U.S. GAAP, and uses U.S. GAAP for no purpose, then the taxpayer may determine the treatment of a book item by using the books maintained by the taxpayer. The amount of gross assets is determined by ascertaining whether the gross assets were $250 million or greater for book purposes at the end of any financial accounting period in which the transaction occurs.

Taxpayers will disclose reportable transactions on Form 8886.

[58] TD 9108.

**List maintenance requirements:**

Under the final rules, a person is a material advisor if he is required to register a transaction under Section 6111, or receives at least a minimum fee with respect to the transaction and makes a tax statement to certain taxpayers. “Fees” are all fees for services for advice or for the implementation of a transaction that is a potentially abusive tax shelter.

The procedures for asserting a privilege claim apply to information required to be maintained in Treas. Reg. Sec. 301.6112-1(e)(3)(i)(I) that might be privileged.

The final rules generally apply to transactions entered into on or after February 28, 2003.

When the temporary tax shelter disclosure regulations were revised, there was some concern that due to the fact that statutory accounting is the starting point for insurance company taxable income, common GAAP to STAT adjustments would be considered significant book-tax differences under the regs and require disclosures. While the final regulations do revise the book-tax difference factor to provide for the limited use of other than GAAP accounting as the starting point, it provides so only if a taxpayer in the ordinary course of its business keeps books on a basis other than U.S. GAAP and does not use U.S. GAAP for any purpose. If the company uses only Statutory accounting, the requirement would be waived.

To further address the potential for significant book-tax difference disclosures, the IRS published Rev. Rul. 2003-25 along with the final regulations. The Rev. Rul. lists thirty book-tax differences which are exempt from the tax shelter listing and disclosure requirements, many of which are common transactions that have no (tax shelter) taint; nonetheless, many other common transactions will be caught within these rules. It is anticipated that the IRS will continue to add common transactions to this list under the presumption that they only wish to gather transactions that are deemed abusive.

> *Former IRS Chief Counsel B. John Williams, speaking at the Court of Federal Claims' (COFC) 16th Annual Judicial Conference on October 14, predicted that highly-complicated, big-dollar tax shelter litigation will continue to rise. Williams suggested that a variety of pressures could lead to an increase in COFC shelter litigation, despite recent IRS settlement initiatives. He asserted that a desire to avoid the reach of the Service's expanded policy on requesting tax accrual workpapers, or to address the economic substance doctrine in a national court, could propel a refund suit.*
>
> Robert Wearing, *Williams Comments on Approaching Wave of Shelter Litigation*, Tax Notes Today, Oct. 15, 2003, 200-6.

## Book-tax differences: Rev. Proc. 2003-25[59]

Revenue Procedure 2003-25 excludes certain book-tax difference transactions from the disclosure requirement. Exceptions of particular interest to insurance companies include the following:

- Items to the extent a book loss or expense is reported before or without a loss or deduction for federal income tax purposes.
- Items to the extent income or gain for federal income tax purposes is reported before or without book income or gain.
- Depreciation, depletion, and amortization relating solely to differences in methods, lives, or conventions
- Capitalization and amortization, under certain conditions.
- Federal, state, local, and foreign taxes.
- Tax exempt interest, including municipal bond interest.
- Dividends, under certain conditions.

[59] Rev. Proc. 2003-25, 2003-11 I.R.B. 1.

- Items resulting from differences solely due to the use of hedge accounting, under certain conditions.
- Inside buildup, death benefits, or cash surrender value of life insurance or annuity contracts.
- Life insurance reserves determined under section 807 and non-life insurance reserves determined under section 832(b).
- Capitalization of policy acquisition expenses of insurance companies.

These rules, as expressed in the regulations, are intended to highlight transactions where deductions are taken for tax before they are taken in the financial statements and where income is taken in the financial statements before it is recognized for tax purposes. As that is the basis of most tax planning, companies should expect disclosure on significant transactions and be prepared to support and defend their positions. Because these regulations are complicated and the regulations and accompanying Revenue Procedures have, and will likely continue, to evolve, taxpayers should consult their internal and external tax advisors for advice on compliance.

*Also making compliance with the tax shelter regulations difficult is the definition of "transaction." Under the regulations, a transaction includes "all of the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement, and includes any series of steps carried out as part of that plan."*[60] *Thus, for example, it is unclear whether a book-tax difference related to reserves is to be calculated on a policy-by-policy basis or whether the reserve for all similar policies must be aggregated. During 2003, PricewaterhouseCoopers submitted comments to the Treasury addressing the definition of "transaction" for purposes of the tax shelter regulations.*

[60] Treas. Reg. Sec. 1.6011-4(b)(1).

## Loss transactions: Rev. Proc. 2003-24[61]

Rev. Proc. 2003-24 excludes certain loss transactions from the disclosure requirement. The first and ostensibly broadest exclusion is intended to exempt from disclosure transactions producing real economic losses. Under the revenue procedure, no disclosure is required with respect to a transaction that meets five criteria:

1. The taxpayer's basis in the asset is a "qualifying basis,"
2. The asset is not an interest in a pass-through entity,
3. The loss is not ordinary under section 988,
4. The asset has not been separated from the income it generates, and
5. The asset is not a mixed straddle.

However, Rev. Proc. 2003-24, defines "qualifying basis" narrowly as the amount paid in cash for the asset, less any adjustments for depreciation, amortization, or casualty loss.

Because in most reinsurance transactions, liabilities are exchanged for assets, the taxpayer would not have a "qualifying basis" in such assets. In the absence of a qualifying basis, the exclusion provided by Rev. Proc. 2003-24 would not apply. Accordingly, taxpayers would be required to disclose any section 165 loss sustained in a subsequent disposition of such assets, if such loss meets or exceeds the relevant thresholds.

Applying this rule will be very difficult for companies which regularly engage in reinsurance transactions since they will need to track the assets they acquire through reinsurance separately as assets with "non-qualifying" basis. Further, while the regulations apply for transactions after the effective date (i.e., generally, transactions entered into on or after January 1, 2003), previously acquired assets are not grandfathered. Thus, companies will need to evaluate the basis of any asset sold on or after January 1, 2003 at a loss meeting the applicable thresholds to determine whether the asset was acquired under a reinsurance transaction and/or whether the taxpayer's basis is, at the time of disposition, a "qualifying basis."

[61] Rev. Proc. 2003-24, 2003-11 I.R.B. 599.

## Producer-owned insurance companies: Notice 2002-70

Notice 2002-70, issued in October 2002, identified as a listed tax shelter transaction certain arrangements used by taxpayers to shift income to related companies purported to be insurance companies that are subject to little or no U.S. federal income tax. Complying with this Notice has remained an issue for many insurance companies and their advisors.

The regulations are drafted very broadly with respect to listed transactions, which apply to "substantially similar" transactions as well. The regulations provide that the term "substantially similar" includes "any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Further, the term 'substantially similar' must be broadly construed in favor of disclosure.

> *Congressional Republicans and Democrats said yesterday that they were looking into supposedly tiny, tax-exempt insurance companies and how they have been used to shield many millions of dollars of investment profits from taxes. The technique is legal. But some experts on insurance and taxes say many of these companies are a tax dodge that should be blocked.*
>
> David Cay Johnston, *Tiny Insurers Face Scrutiny as Tax Shields*,
> The New York Times, Apr. 4, 2003, Page 1, Column 5.

As taxpayers grapple with determining substantially similar transactions to Notice 2002-70, consideration should be given as to one that fits the following profile:

- Taxpayer transfers income from a related company,
- Said related company is treated as an insurance company for U.S. tax purposes regardless of actual domicile, and

- Taxpayer further structures such insurance company to take advantage of one of the special provisions applicable to small insurance companies, i.e.,

  1. Section 501(c)(15) which exempts certain P&C companies with premiums less than $350,000;
  2. Section 831(b) which permits certain P&C companies with premiums between $350,000 and $1,200,000 to elect to be taxed only on investment income; or
  3. Section 806, which provides special deductions for life insurance companies with LICTI not in excess of $15 million or with assets with a fair market value greater than or equal to $500 million.

- The tax benefit stemming from the transaction includes
  - The ability to shift income from Taxpayer to the captive insurance company;
  - The ability of the captive to immediately deduct reserves;
  - The ability of the related Taxpayer to deduct premiums paid (either immediately or over the life of a multi-year policy); and
  - If the insurance company qualifies as a "small" insurance company under either of the above three special provisions, sections 501(c)(15), 831(b), or 806, the ability of the captive insurer to reduce or eliminate, on an ongoing basis, its Federal income tax liability.

- The tax structure (which the final regulations broadly define to include *"any fact that may be relevant to understanding the purported or claimed Federal income tax treatment of the transaction"*) includes, at a minimum, an employer's attempt to take advantage of sections 501(c)(15), 831(b) or 806.

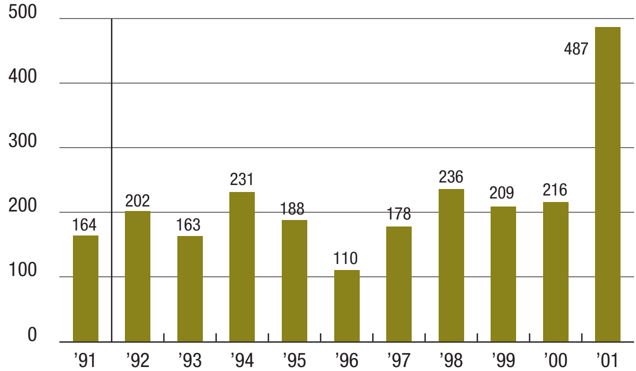
- The tax strategy (an undefined term) would appear to be the federal tax reduction or elimination of earnings on insurance operations through the use of insurance accounting and special tax rules afforded to insurers.

While it may be possible to implement this transaction with certain factual distinctions (e.g., use of a domestic insurance company, expansion to an industry beyond automobile-related credit, life and vehicle service reinsurance programs, use of a brother-sister rather than parent-sub corporate structure, use of a captive with little or no investment income) it does not appear that these factual differences would sufficiently distinguish the transaction to eliminate disclosure obligations. Any transaction involving a captive structured to shift income from the Taxpayer to a small insurance company structured to take advantage of section 501(c)(15), section 831(b) or section 806 could be construed by the IRS to be substantially similar to Notice 2002-70.

Notwithstanding the need to disclose transactions that are substantially similar to that described in Notice 2002-70, companies that sell and reinsure insurance products in the ordinary course of their trade or business that enter into valid arm's length transfer pricing for commissions and premiums should withstand IRS scrutiny for claiming benefits to which they are properly entitled under the Internal Revenue Code. Taxpayers should ensure that pricing is arms-length and that the structure and operations of the captive comport with insurance industry practices.

Many insurance companies participate in the operation of an unrelated insurance company, and as a result, may be a material advisor under the regulations, and may be subject to the list maintenance requirement. Taxpayers should be aware of their responsibility to maintain lists of potentially abusive tax shelters for which they have been material advisors, including "producer-owned reinsurance companies."

### Shareholder class actions lawsuits, 1991-2001[1]




[1] Securities fraud suits filed in U.S. federal courts.

*Source:* Stanford University School of Law; Woodruff-Sawyer & Co., Insurance Information Institute, Property & Casualty Fact Book, 2003, 128.

## Tax accrual workpapers – Chief Counsel Notice 2003-12

In addition to the final tax shelter regulations and Revenue Procedures, the IRS released Chief Counsel Notice 2003-12[62], outlining procedures for IRS requests of tax accrual and other tax-related financial audit workpapers. The Chief Counsel Notice modifies procedures for requests for audit and tax accrual workpapers that are not affected by Announcement 2002-63[63] which provided that the IRS could request tax accrual workpapers while examining any return filed on or after July 1, 2002, that claims a tax benefit from a listed transaction.

### Returns involving listed transactions

The Notice states that an information document request generally will be limited to the tax accrual workpapers related to the listed transaction for the years under examination; however, all tax accrual workpapers may be requested if:

[62] Chief Counsel Notice 2003-12.

[63] Announcement 2002-63, 2002-27, I.R.B. 1.

- A taxpayer failed to disclose a listed transaction on a return filed after July 1, 2002;
- A taxpayer claimed benefits from multiple investments in listed transactions on a return filed after July 1, 2001, regardless of whether the transactions are disclosed; or
- There are reported financial irregularities.

**Requests not covered by Announcement 2002-63 or Notice 2003-12**

Under the Notice, neither existing procedures nor those set out in Announcement 2002-63 apply to requests for tax reconciliation workpapers and audit workpapers.

Although the IRS has long had broad authority to request tax accrual workpapers, it has historically declined to use such authority as a standard examination technique. The new policies are intended to change taxpayer behavior by raising the stakes of investing in "aggressive transactions."

## Year-end tax shelter developments

The IRS released guidance related to abusive tax avoidance transactions that is intended to heighten standards for tax advisors and increase transparency and disclosure of information to the IRS. The changes include new guidance under Circular 230, final regulations on disclosure of reportable transactions, and information reporting for foreign disregarded entities.

### *Proposed changes to Circular 230* [64]

Proposed changes to Circular 230 provide best practices for tax advisors and modify standards for certain tax shelter opinions. The proposed rules give specific requirements for tax opinions and require certain disclosures. They also call on professional services firms to put

[64] Fed. Reg. 122379-02, Dec. 19, 2003.

in place procedures for all of the firm's personnel that are consistent with the described best practices. The proposed rules would replace changes proposed in January 2001, and are proposed to apply on the date final regulations are published.

### *Final regulations on disclosure of reportable transactions*

Final regulations under Sections 6662 and 6664[65] affect the defenses available to the imposition of the accuracy-related penalty for failure to disclose reportable transactions or positions taken contrary to Treasury regulations. The final rules narrow a taxpayer's ability to establish good faith and reasonable cause as a defense, where the taxpayer fails to disclose a transaction required to be disclosed by the final disclosure regulations. The final regulations apply to returns filed after December 31, 2002 with respect to transactions entered into on or after January 1, 2003.

*Investment banking firm JP Morgan Chase & Co. said it has settled its legal dispute with 11 insurers over surety contracts related to failed energy trader Enron Corp.*

**By the numbers**

Individual settlement figures were reported by the following insurers:

- **Travelers Property Casualty Corp.:** $139 million, plus related bankruptcy rights.
- **Chubb Corp.:** $95.8 million, plus related bankruptcy rights.
- **CNA Surety:** $40.7 million, including bankruptcy rights
- **Hartford Financial:** $21 million, plus related bankruptcy rights.
- **Safeco:** $18 million pretax.
- **Liberty Mutual:** Under $12 million.
- **St. Paul Cos.:** Will take after-tax charge of $5 million related to settlement.

David Pila, "JP Morgan, Insurers Settle in Enron Dispute," Best Week, Jan. 6, 2003, 5.

[65] TD 9109.

### *Information reporting for foreign disregarded entities*

In Ann. 2004-4[66], the IRS proposed new Form 8858, requiring information reporting by U.S. persons that own foreign entities that are disregarded for U.S. tax purposes. The IRS states that the need for information is not limited to the area of abusive tax avoidance transactions and that appropriate disclosure and information reporting requirements focus audit resources cost-effectively. The reporting of information on Form 8858 would be required for annual accounting periods beginning on or after January 1, 2004.

## Joint committee on taxation, Enron report

The Joint Committee on Taxation (JCT) released its staff analysis of Federal income tax returns filed by Enron Corporation. In its report, the JCT staff challenged the validity or propriety of a number of relatively common features under Enron's compensation plans including (1) the ability of participants to accelerate distributions through hardship withdrawals, (2) the ability of participants to accelerate distributions at any time through a 10-percent forfeiture and exclusion from the deferral plan for 36 months, (3) the ability of participants to change distribution elections at any time, (4) the security afforded by rabbi trusts, in combination with corporate- or trust-owned life insurance policies, (5) the ability of participants to "direct the investment" of their salary, bonus, and incentive deferrals, and (6) the ability of participants to defer income that otherwise would be recognized upon exercise of stock options.

After evaluating the Enron compensation plans, the JCT staff report made four major recommendations with respect to deferred compensation plans.

(1) Changing present-law rules regarding the tax treatment of executive compensation to preclude tax benefits for arrangements that provide security or control for covered executives.

[66] Announcement 2004-4 (30 Dec 2003).

(2) Precluding deferral of stock option gains and restricted stock.

(3) Repealing the TRA 86 grandfather that permits deductions for interest paid on policy loans against policies purchased before June 20, 1986.

(4) Repealing the $1 million limitation on deductions for executive compensation.

The JCT staff also recommended that taxpayers should be required to include in income the economic value of benefits provided through a split-dollar arrangement. This approach was taken in the final split-dollar regulations released later in the year.

*The Treasury Department launched an offensive to stop investors from using insurance "wrappers" to defer or even avoid taxes on certain types of investments such as hedge funds. The Treasury said two new rulings are designed to curtail the "abusive use" of life-insurance and annuity contracts to escape paying current taxes on investment earnings. Treasury officials believe the improper use of insurance wrappers is a significant problem, especially among the wealthy.*

Tom Herman and Theo Francis, *Tax-Avoidance Device is Attacked*,
The Wall Street Journal, Jul. 24, 2003, D2.

# Reorganizations

chapter 6

For years industry commentators have been predicting rapid and widespread insurance industry consolidation that would result in a relatively small number of dominant players. Despite these predictions, the industry continues to be populated with a significant number of smaller, regional insurers, while mergers, spin-offs, and reorganizations have continued at a *reasonable* pace.

In 2003, developments in reorganizations revolved more around what was missing than what was present. Final regulations under section 338(h)(10) were not released during 2003. The controversial proposed regulations were issued in 2002 and final regulations were included in the IRS business plan; however the end of the year passed without further guidance.

Despite the lack of major developments in the area of reorganizations, the IRS issued several rulings regarding mutual conversions, where the outcome continued to be taxpayer-favorable, and the facts and rulings outlined were consistent with previously-issued rulings. The IRS also issued a ruling relating to an 831(b) election revocation.

## Mutual conversions

### Rev. Rul. 2003-19[67]

The IRS described the tax consequences resulting from three fact patterns involving a mutual company conversion. In each of the situations Mutual Company plans to convert from a mutual insurance company to a stock insurance company. Situation One involves a "straight conversion" in which Mutual Company authorizes the issuance of capital stock and changes its name to Stock Company. Situation Two involves a "Mutual Holding Company Structure" in which Mutual Company incorporates Mutual Holding Company, which, in turn, incorporates Stock Holding Company. Situation Three involves a "Mutual Holding Company Conversion and Acquisition" in which Mutual Holding Company owns all of the stock of Stock Holding Company, which owns all of the stock of Stock Company 1, a stock insurance company.

> *Americans have received billions of dollars of stock as mutually owned insurers converted into publicly traded companies. The IRS says when these shareholders sell those shares, they must pay capital-gains taxes on the full amount. Now, a few tax professionals and academics are saying the IRS is being overly harsh. They have concluded that policyholders didn't get something for nothing when they received shares. Instead, they got their ownership positions by paying premiums, and the shares represent a return of the premiums – not a gain. The Treasury says the IRS is right.*
>
> Theo Francis and Tom Herman, *How to Tax Some Insurers' Shares*,
> The Wall Street Journal, Aug. 28, 2003, D2.

In Situations 1, 2, and 3, because Stock Company is the same corporation as Mutual Company under State law, the conversion from a mutual insurance company to a stock insurance company is a reorganization under Sections 368(a)(1)(E) and 368(a)(1)(F). The acquisition of Stock Company in Situation 3 is a Section 368(a)(1)(B) reorganization. In all

[67] Rev. Rul. 2003-19, 2003-7, I.R.B. 1.

three situations, all policies remain in force, and continue to offer life insurance and annuity products. Further, no amount credited to a policyholder's account is taxable until actually distributed.

### PLR 200333024[68]

The IRS ruled that a mutual P&C company's conversion to a stock corporation is a tax-free reorganization.

Holding Company will issue non-transferable subscription rights for its no par value common stock. Upon completion of the Offering, Insurance Company will convert from mutual to stock form. As a result of additional transactions, the Converted Company will be a wholly owned subsidiary of the Holding Company.

The IRS ruled that the conversion of Insurance Company into Converted Company will be a reorganization under section 368(a)(1)(E). Further, no gain or loss will be recognized by Holding Company, Insurance Company, or Converted Company, and Insurance Company's tax attributes will carry over.

### PLR 200307080[69]

Company (a mutual company) owns all the stock of Intermediate, which owns all the stock of Life Insurance Company.

Life Insurance Company was placed under rehabilitation by the state Department of Insurance. While under administrative supervision, Company sold the stock of Intermediate, including Life Insurance Company. Soon after the sale, the state Rehabilitator revised the status of Company from rehabilitation to liquidation. Company will be liquidated by making cash distributions to the Eligible Members. Because of the period between the record date and the earliest possible distribution, all distributions to Eligible Members will be for Membership Interests held for more than one year.

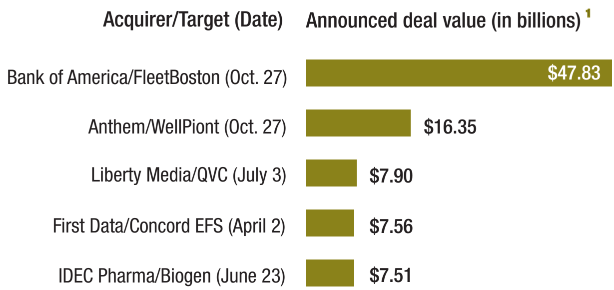
[68] PLR 200333024 (Aug. 15, 2003).

[69] PLR 200307080 (Feb. 14, 2003).

The IRS found that the liquidation of a mutual holding company following the sale of its subsidiaries produces long-term capital gain for members who held polices through the insurance subsidiary.

## Biggest 2003 deals

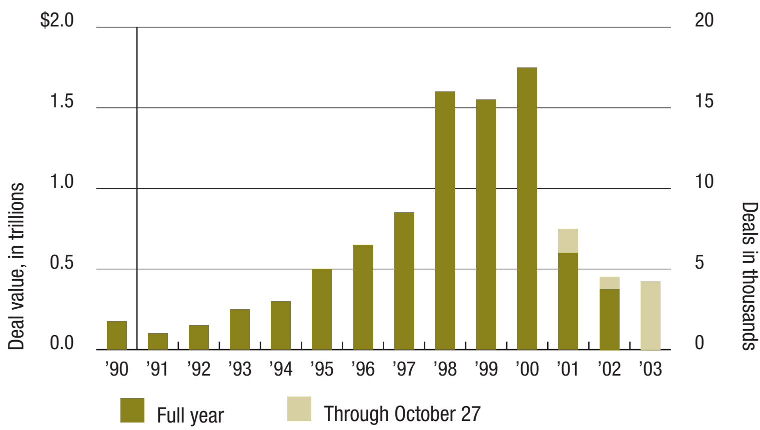
Top five U.S. mergers and acquisitions in 2003




[1] Deal values include net debt of target company

## Yearly volume

Annual U.S. merger activity




*Source:* "After Dry Spell, a Merger Flood," The Wall Street Journal, Oct 28, 2003, C1.

## Restructurings

### PLR 200302022[70]

Parent Group elects under Section 1504(c)(2) to include eligible life insurance companies in its consolidated return. In order to address structural problems which create confusion and troublesome management issues, the taxpayers proposed a transaction in which Holdco 2 will liquidate into Holdco 1 under Section 332, and Parent will statutorily merge into Holdco 1 under Section 368(a)(1)(A). Lower tier subsidiaries will distribute certain business assets to Holdco 1, which will redistribute them to separate subsidiaries.

The IRS ruled as that that the consolidated group and its life-nonlife election remain in existence after the restructuring.

### PLR 200303028[71]

Parent is a life insurance company that issues life insurance policies and annuity contracts. Subsidiaries A and B are also life insurance companies. Subsidiaries cede virtually all of their premium and risk to Parent on a coinsurance or modified coinsurance basis. Parent and Subsidiaries A and B file a consolidated federal income tax return.

In order to simplify its structure, reduce expenses, and concentrate its focus, Parent plans to liquidate Subsidiaries into itself. All of the assets and liabilities of Subsidiaries will be transferred to Parent, and Subsidiaries will cease to exist. Included among the assets and liabilities are the Subsidiaries' insurance policies and annuity contracts. As a result of the liquidation, Parent will become the sole obligor under the Policies. Parent will not issue new contracts in exchange for existing Policies. The liquidation will qualify as a complete liquidation under Section 332.

The IRS ruled that the liquidation will have no effect on the date that the Policies were issued, entered into or purchased. The liquidation will also not require retesting or a new test period.

[70] PLR 200303028 (Jan. 17, 2003).

[71] PLR 200332014 (Aug. 8, 2003).

*Total insurance deal value soared to $14 billion, from $823 million in the third quarter of 2002, due to the announcement of three major deals: the acquisition of John Hancock Financial Services Inc. by Manulife Financial Corp.; the acquisition of MONY Group Inc. by AXA S.A.; and a move by a private investment group to acquire Financial Guaranty Insurance Company from General Electric.*

Allison Bell, *SNL Says M&A Activity Soars in Third Quarter*, National Underwriter, Oct. 17, 2003, no page.

## Section 831(b) revocations

### PLR 200332014[72]

Taxpayer is a mutual property insurance association which previously elected to be taxable only on its investment income under section 831(b). Subsequently, Target, a non-life insurance company exempt from taxation under section 501(c)(15), merged into Taxpayer.

At the time Taxpayer made the section 831(b) election, Taxpayer was writing predominately farm policies. With the reduction of the number of farms, Taxpayer's current writings are growing towards homeowner and light commercial agricultural policies. Taxpayer's average risk quadrupled since it made its section 831(b) election. Further, when Target merged with Taxpayer, the merger resulted in an increase of 167% in gross premiums, a 170% increase in gross assets, and a 162% increase in taxable investment income.

The IRS granted consent to the revocation of Taxpayer's section 831(b) election after determining that Taxpayer showed that the nature of its business had changed substantially.

[72] PLR 200332014 (Aug. 8, 2003).

# International developments

chapter 7

As the insurance world is increasingly global, international developments are becoming more and more important in decision-making, risk-management, and compliance. During 2003, the industry was inundated with new international rules from a variety of sources, including the Internal Revenue Service, legislators, international decision-making bodies, and tax courts. Continuing a trend from prior years, much attention was given to increasing transparency of international transactions and curbing tax avoidance. However, initiatives were also in place which were designed with the intent of lessening taxpayers' compliance burdens. All of these initiatives will have a direct and long-lasting effect on the insurance industry.

# Transfer pricing

## Transfer pricing regulations[73]

The IRS issued proposed regulations on transfer pricing for services, including services related to intangible property. The current regulations were issued in 1968 and are the only significant part of the 1968 transfer pricing regulations that were not addressed by updated regulations in 1994 and 1995.

The proposed regulations provide guidance in three specific areas: Transfer Pricing Methods, Cost Safe Harbor, and Ownership of Intangibles.

*As part of its overall transfer pricing enforcement initiative, the IRS through its Large and Midsize Business Division issued a directive mandating that transfer pricing documentation will be an area of focus in any current or prospective audit. As of January 22, 2003, any company under LMSB jurisdiction will be asked at the initial IRS audit conference to produce transfer pricing documentation within 30 days of the request.*

Sindhu Hirani and Richard Barrett, *IRS Directive Adds Pressure for Companies Under Audit to Produce Transfer Pricing Documentation*, WTS Release, PricewaterhouseCoopers, Feb. 19, 2003.

The regulations contain provisions that would directly affect insurance companies. The preamble and Treas. Reg. Sec. 1.482-9(f)(4)(v) provide that insurance or reinsurance transactions are not eligible for the safe harbor simplified cost-based method. Additionally, an example in the proposed rules refers to a U.S. insurance company whose wholly-owned foreign subsidiary provides specialized risk analysis for the U.S. company as well as other uncontrolled parties.

[73] 68 Fed. Reg. 146893-115037 (Sept. 10, 2003).

The new regulations are far reaching and complex, and as such should be reviewed carefully by virtually all taxpayers. The regulations are effective for taxable years beginning on or after the date of publication as final regulations in the Federal Register.

## PATA documentation package

The Pacific Association of Tax Administrators (PATA) finalized a Transfer Pricing Documentation Package that theoretically allows taxpayers to produce one transfer pricing documentation package to satisfy all documentation requirements for related party transactions of a multinational enterprise between PATA member countries (Australia, Canada, Japan, and the U.S.). However, the Package amounts to a combining of each PATA members' separate transfer pricing documentation requirements, rather than limiting the extent of documentation required. The failure to incorporate relevance, materiality, or cost of preparing the documentation into consideration is a significant disappointment to transfer pricing specialists.

Preparation of the final package is voluntary and appears to provide broad penalty protection. Additionally, under the Package, there are **(1)** no legal requirements greater than those imposed under local law, (2) limits on a PATA member's ability to request documentation that is not related to transactions involving the tax authority's respective country, and (3) provisions that specify that the list of items required is "exhaustive" and requires no additional documentation.

The PATA Documentation Package may provide some relief to taxpayers by providing clearer requirements. The Documentation Package is expected to be a starting point for a similar project by the Organization for Economic Cooperation and Development (OECD).

**TRANSFER PRICING DIRECTIVE**

*As of January 22, 2003, any company under the Large and Midsize Business Division's (LMSB) jurisdiction will be asked at the initial IRS audit conference to produce transfer pricing documentation within 30 days of the request. The intensified IRS focus on transfer pricing reflects current concerns relating to international cross-border transactions, corporate inversions, and section 163(j) "earnings stripping" rules.*

*In light of the directive, companies should focus on preparing documentation contemporaneously with filing the income tax return. The documentation should support the "arm's-length nature" of the company's pricing as it relates to all intercompany transactions.*

*Moreover, because these intercompany issues generally are present not only in the current cycle but in future audit cycles, a company should consider carefully how it responds to an IRS inquiry. Any response also must weigh the implications surrounding how the cross-border transaction could be viewed in the foreign jurisdiction.*

## Subpart F

The IRS released two Revenue Procedures, one addressing assets included in the NAIC annual statement and the other outlining new procedural rules for the section 953(d) election. The IRS also released two Private Letter Rulings addressing whether reserves held by foreign subsidiaries which are set forth on financial statements and filed with the insurance regulator of their countries of domicile are an appropriate means of measuring income under Subpart F. In both cases, the IRS issued favorable rulings for the taxpayer. While these rulings do not necessarily mean that companies can now freely rely on measuring income under Subpart F based on reserves held by a foreign subsidiary, it does mean that reserves can be relied on to the extent that a foreign jurisdiction's level of regulatory control and disclosure requirements are comparable to the countries in the rulings.

## Rev. Rul. 2003-17[74]

FC, a foreign life insurance company, maintains an insurance business within the U.S. FC is required to retain trusteed assets and deposits in the U.S. sufficient to satisfy all potential claims of its U.S. policyholders. While the trusteed assets are included on the NAIC statement, FC also maintains non-trusteed assets which are not reflected in the NAIC statement.

The IRS concluded that FC is taxable on any income effectively connected with its U.S. trade or business and that, while due regard will be given to the NAIC statement, it is not determinative of the amount of effectively connected income. Further, due regard also must be given to the fact that FC has accounted for the non-trusteed assets on the books of the U.S. branch.

## Rev. Proc. 2003-47[75]

The IRS released Rev. Proc. 2003-47 providing new procedural rules for the 953(d) election which allows certain foreign insurance companies to elect to be treated as domestic corporations for U.S. tax purposes.

Several changes are made in the Rev. Proc. including a new mailing address for elections and the replacement of Form 2848-D by Form 8821 ("Tax Information Authorization"). Additionally, the Rev. Proc. gives specific procedures for satisfying the Office and Asset Tests, including procedures for taking into account the office and assets of a U.S. affiliate. The Rev. Proc. also requires that the electing corporation, or its U.S. affiliate, provide a calculation demonstrating that the requirements of the Asset Test are met.

[74] Rev. Rul. 2003-17, 2003-6, I.R.B. 1.

[75] Rev. Proc. 2003-47, 2003-28, I.R.B. 1.

**DEATH AND TAXES:**

*A tax office official in Finland who died at his desk went unnoticed by up to 30 colleagues for two days. According to the Finnish tabloid newspaper Ilta-Sanomat, co-workers had assumed the dead man – a tax auditor – was silently poring over returns. There were about 100 other staff in the auditing department on the same floor the dead tax official worked on. Finnish citizens pay among the highest taxes in the world, but enjoy one of the best welfare systems.*

"Finns Miss Death in Tax Office," BBC News, Jan. 19, 2004, no page.

## PLR 200327052[76]

The IRS ruled that the underwriting, loss, and policyholder dividend reserves required by Foreign Agency were an appropriate means of measuring income under Subpart F for a domestic corporation with two wholly-owned foreign life insurance subsidiaries.

As required by the insurance laws of the Subsidiaries' country of domicile: **(1)** Subsidiaries file audited annual reports; **(2)** the accounting records that form the basis for the Annual Reports are subject to inspection; and **(3)** Subsidiaries' Annual Reports are available to the public. Subsidiaries must maintain underwriting, loss, and policyholder dividend reserves for obligations to holders of their insurance and annuity contracts and must set forth the amount of such reserves on the Annual Report. The rules for calculating these reserves are prescribed by insurance laws and regulations.

## PLR 200341019[77]

The IRS ruled that certain reserves required by Foreign Agency were an appropriate means of measuring income under Subpart F for a domestic corporation with a foreign life insurance subsidiary.

[76] PLR 200327052 (Jul. 3, 2003).

[77] PLR 200341019 (Oct. 10, 2003).

Under Country A's insurance laws and regulations **(1)** CFC must file an annual report and financial statements; **(2)** CFC must submit a written actuarial opinion on the adequacy of policy reserves; **(3)** the Agency may appoint an independent actuary to determine the adequacy of the opinion; **(4)** the Agency may examine CFC's books at any time; and **(5)** CFC must establish and maintain certain liabilities and reserves. CFC would be subject to tax under Subchapter L if it were a domestic corporation.

## Offshore investments

### Notice 2003-34[78]

The IRS warned that arrangements involving an investment in an offshore insurance company which invests in hedge funds and is used to defer recognition of ordinary income or to characterize ordinary income as a capital gain often do not generate the claimed tax benefits. The IRS will scrutinize these arrangements and will apply the PFIC rules where it determines that companies are not insurance companies for federal tax purposes.

The typical arrangement involves a U.S. Stakeholder investing in a foreign insurance corporation. The company's actual insurance activities are relatively small compared to its investment activities. The stakeholder takes the position that the insurance company is an insurance company engaged in the active conduct of an insurance business and is not a passive foreign investment company. Therefore, when Stakeholder disposes of its interest in the company, it recognizes capital gain, rather than ordinary income.

[78] Notice 2003-34, 2003-23, I.R.B. 990.

> *The US Internal Revenue Service has stepped up scrutiny of offshore partnership plans, while Congress is to consider outlawing them in the future. The moves are the latest regulatory challenges facing the hedge fund industry, which has been hit by scandals and faces investigation by the Securities and Exchange Commission.*
>
> Robert Clow and Elizabeth Rigby, *IRS Takes Close Look at Offshore Deferral Schemes*, Financial Times, Jan. 28, 2003, 32.

The Notice states that if companies would not be subject to tax under subchapter L if they were domestic corporations, then the insurance income exception to passive income does not apply. Additionally, even if the companies would be subject to tax under subchapter L if they were domestic corporations, the insurance income exception may not apply because this exception is applicable only to income derived in the active conduct of an insurance business.

## Rev. Proc. 2003-11[79]

The IRS announced an initiative aimed at bringing taxpayers who used "offshore" payment cards or other offshore financial arrangements to hide their income back into compliance with tax law. Requests to participate in the Offshore Voluntary Compliance Initiative had to be submitted by April 15, 2003.

Under the Offshore Voluntary Compliance Initiative, eligible taxpayers who stepped forward did not face civil fraud and information return penalties. However, taxpayers still had to pay back taxes, interest and certain accuracy or delinquency penalties.

The IRS will use the information obtained from the initiative to pursue promoters and to obtain information about taxpayers who have avoided tax and who do not come forward under the Voluntary Compliance Initiative.

[79] Rev. Proc. 2003-11, 2003-4, I.R.B. 3.

# U.S. treaty and excise tax issues

While the Senate ratified an important new income tax treaty, the IRS provided instructions for establishing exemption from the section 4371 excise tax and released three Private Letter Rulings which determined that foreign reinsurance companies were eligible for exemption from section 4371 excise taxes under the terms of the applicable U.S. income tax treaty. Additionally, the IRS issued two Notices for use in determining whether dividends paid by foreign companies can qualify for the new maximum 15-percent rate of tax on qualified dividends received by U.S. non-corporate taxpayers.

## U.S./U.K. income tax treaty[80]

The U.S. and the U.K. ratified an income tax treaty that was signed in 2001. Although the ratified treaty is effective generally on January 1, 2004, various provisions have different effective dates. The Senate made no changes in the treaty during the ratification process. However, since the original treaty was signed, the U.S. and the U.K. signed a Protocol which was also ratified by the Senate.

The Protocol made changes to the Limitation on Benefits and Pension provisions which improve the treaty benefits relating to pension plans. The Protocol also modified the definition of "equivalent beneficiaries" in the Limitation on Benefits article and eliminates a controversial provision that would have extended benefits of the treaty to a company owned by residents of the European Community.

Importantly, the treaty includes an "anti-conduit" rule to disallow the excise tax exemption for risks ultimately reinsured outside of the U.K.

[80] Convention between the Government of the United States of America an the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation an the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains. Signed July 24, 2001.

> *As the Bush administration seeks freer global trade in services, the European Union is taking aim at the sector and requesting changes in how U.S. state and federal authorities regulate everything from liquor sales to accounting. The EU requests, put forward as part of continuing global trade talks, are likely to raise alarm among state and local authorities, who would be required to alter rules governing businesses ranging from land ownership to insurance. Some of the EU positions have been known for months, but the final list includes new language regarding accounting standards, cross-border insurance and the retail sale of electricity, all highly controversial topics.*
>
> Neil King, *EU Asks U.S. to Revise Rules for Service Sector*,
> The Wall Street Journal, Feb. 25, 2003, A3.

## Rev. Proc 2003-78 [81]

The IRS provided instructions for establishing exemption from the section 4371 excise tax on insurance premiums paid to a foreign insurer or reinsurer when the exemption is based on the provisions of an income tax treaty to which the United States is a party.

Under the Rev. Proc., a person otherwise required to remit the insurance excise tax may consider the premiums exempt from the tax under a tax treaty if the premiums are paid to an insurer that is a resident *for treaty purposes* of a country with which the United States has a treaty containing an excise tax exemption and, prior to filing the return, the person knows that there was in effect a closing agreement between the IRS and the foreign insurer or reinsurer. However, a person required to remit the excise tax may not consider the premiums exempt if prior to filing the return the person knows that the insurer did not qualify for benefits under the relevant treaty during the taxable period.

[81] Rev. Proc. 2003-78, 2003-45, I.R.B. 1029.

The Rev. Proc. contains two closing agreement forms, one for treaties with qualified exemptions and one for treaties with an exemption subject to an anti-conduit arrangement limitation.

Companies should review the treaty under which they are claiming exemption to see if further action is necessary.

### PLR 200321013 [82] and PLR 200323016 [83]

The IRS released several Private Letter Rulings concluding that Taxpayers, all reinsurance companies organized in Ireland, satisfied the active trade or business test of Article 23(3) of the U.S.-Ireland income tax treaty and were eligible for benefits under the Treaty.

In each case, Taxpayer was a resident of Ireland, subject to the generally applicable Irish tax imposed on Irish insurance companies. All of Taxpayer's gross income consisted of premiums and investment earnings attributable to such premiums, as well as from investment of its business capital. The premium income it received from U.S. insureds was generated by an activity that formed a "part of" its trade or business in Ireland.

### PLR 200327047 [84]

Taxpayer, a resident of the Federal Republic of Germany, is a foreign reinsurance company. Taxpayer represents that it is engaged in an active trade or business in Germany and that the premium income it receives from the United States is derived in connection with, or is incidental to, that trade or business. Therefore, Taxpayer contends that it qualifies for benefits under Article 28(1)(c) of the Convention.

The IRS found that Taxpayer satisfied the requirements of Article 28(1)(c) of the Convention and is exempt from section 4371 excise taxes on qualified risks.

[82] PLR 200321013 (May 20, 2003).

[83] PLR 200323016 (Jun. 6, 2003).

[84] PLR 200327047 (Jul. 2, 2003).

> *The board charged with cleaning up the accounting industry recommended yesterday that foreign auditors of companies whose shares are traded in the United States be required to register with U.S. regulators. By proposing to extend its reach overseas, the Public Company Accounting Oversight Board, adds to a fierce international debate. Representatives of the European Union and the governments of Switzerland and other countries have told board members in the past week that foreign auditors must not be made to face conflicting laws and rules.*
>
> Carrie Johnson, *Accounting Board Wants Foreign Firms to Register Overseas Auditors Protest Dual Standards*, The Washington Post, Mar. 5, 2003, E03.

## Notice 2003-69[85] and Notice 2003-71[86]

The IRS announced separately a list of U.S. income tax treaties and the definition of "readily tradable on an established U.S. securities market." The two items are to be used in determining whether dividends paid by foreign companies can qualify for the new maximum 15-percent rate of tax on qualified dividends received by U.S. non-corporate taxpayers.

The Jobs and Growth Tax Relief Reconciliation Act of 2003[87] generally provided that a dividend paid to an individual shareholder from either a domestic corporation or a "qualified foreign corporation" is subject to tax at the reduced rates applicable to certain capital gains.

Subject to certain exceptions, a qualified foreign corporation is any foreign corporation that is either incorporated in a possession of the United States, or eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory and which includes an exchange of information program. In addition, a foreign corporation not otherwise treated as a qualified foreign corporation is so treated with respect to any dividend it pays if the stock with respect to

[85] Notice 2003-69, 2003-42, I.R.B. 851.

[86] Notice 2003-71, 2003-43, I.R.B. 922.

[87] P.L. 108-27, 117 Stat. 752.

which it pays such dividend is readily tradable on an established securities market in the United States.

Treasury and the IRS intend to update the list published in the Notice, as appropriate. The Notice is effective for taxable years beginning after December 31, 2002.

## Domestic asset/liability percentages

### Rev. Proc. 2003-70 [88]

For the first taxable year beginning after December 31, 2001, the relevant domestic asset/liability percentages are:

- 123.3 percent for foreign life insurance companies, and
- 171.9 percent for foreign property and liability insurance companies.

For the first taxable year beginning after December 31, 2001, the relevant domestic investment yields are:

- 7.0 percent for foreign life insurance companies, and
- 5.7 percent for foreign property and liability insurance companies.

To compute estimated tax and the installment payments of estimated tax due for taxable years beginning after December 31, 2001, a foreign insurance company must add to its income other than net investment income the greater of **(1)** its net investment income effectively connected with the conduct of a U.S. trade or business, or **(2)** the minimum effectively connected net investment income that would result from using the most recently available domestic asset/liability percentage and domestic investment yield.

For installment payments due after the publication of the Rev. Proc., the domestic asset/liability percentages and the domestic investment yields provided in the Rev. Proc. must be used to compute the minimum effectively connected net investment income.

[88] Rev. Proc. 2003-70, 2003-34, I.R.B. 406.

*In early November, the European Commission signaled that it would phase in approximately $4 billion worth of sanctions against U.S. exports, rather than imposing the sanctions all at once, if Congress does not get rid of the U.S. system of export tax breaks by the end of 2003.*

*EU Signals It May Phase in Trade Sanctions if Congress Does Not Prepeal Export Breaks*, BNA Daily, Oct. 21, 2003, G1.

# Foreign tax credit

## Travelers Insurance Company v. Commissioner [89]

The Supreme Court denied Certiorari to Travelers Insurance Company in its suit with the IRS involving the policyholders' share of investment income excluded in calculating Travelers Insurance Co.'s foreign tax credit.

In 1993, the Claims Court granted partial summary judgment finding that "the statutory exclusion was in fact more 'accurately viewed as a deduction' because the excluded amounts reduced the amount of the reserves and hence the deduction allowed for addition to reserves." In September 2002, the Federal Circuit Court of Appeals reversed the 1993 Claims Court ruling. Travelers then appealed to the Supreme Court.

In denying Certiorari to Travelers Insurance Company, the Supreme Court de facto indicated its agreement with the judgment of the Federal Circuit Court of Appeals. The Circuit Court believed that the issue was simple in that if the legislation explicitly states that an amount should be excluded, then it should not be interpreted other than as an exclusion. This demonstrates once again the reluctance of the courts to go beyond the literal meaning of the statute.

[89] Travelers Insurance Company v. United States. No. 02-1745, Oct. 6, 2003.

Life Insurance Companies with foreign ventures in which they are taking the policyholders' share as a deduction in their foreign tax credit calculation, should be aware that the IRS is likely to use the Circuit Court decision to deny foreign tax credits previously claimed.

> *The OECD intends to release a discussion draft on the attribution of profits to permanent establishments. The discussion draft will address whether the existing rules "are appropriate" for taxing business profits. The digital economy has resulted in commenters and countries asking whether current treaty rules are still appropriate, given that PEs were designed in the 19th century.*
>
> Kevin A. Bell, *OECD to Release Permanent Establishment Discussion Draft in November*, Tax Notes Today, Nov. 5, 2003, 2003 TNT 215-7.

## International court cases

### *State Farm v. The Queen*

Services provided to Ontario-based State Farm Mutual Auto Insurance Co. and its subsidiaries by its parent company in the United States are not subject to Canada's Goods and Services Tax ("GST"), the Tax Court of Canada ruled.[90]

The subject of the ruling was whether expenses of State Farm's head office in Bloomington, Illinois that were allocated to State Farm's Canadian Regional Office were subject to the GST. Financial services are exempt from the 7 percent GST, and State Farm argued that any services provided to the Canadian insurer by its head office in Illinois should be GST-exempt.

[90] *State Farm v. The Queen*, Can. Tax. Ct., No. 2001-2224 (GST) G, 1/30/03.

The Canadian Canada Customs and Revenue Agency assumed that a percentage of head offices expenses related to underwriting of insurance policies and the handling of insurance claims should be subject to GST. However, the court determined that “If we assume all of the ingredients otherwise giving rise to taxability we still revert to the fact that State Farm’s business is the supplying of financial services… and it is therefore exempt.”

U.S. insurance companies that allocate costs for services provided to Canadian subsidiaries to those subsidiaries should review this case for possible refund opportunities.

# Blue Cross Blue Shield

# chapter 8

In 2003 the issue of a non-profit, public benefit Blue Cross Blue Shield Plan (Plan) converting to for-profit status was again considered by several states. A handful of Plans were at the center of the controversy regarding their attempted conversions. In the majority of the pending conversion cases, the Plan either withdrew its conversion plan, lost in the court, or had legislation passed that impeded the conversion. While the issue of Plan taxation has been long settled since the enactment of section 501(m), the conversion of a Plan from not-profit to for-profit status can have implications on the Plan's ability to continue to qualify as a section 833 Blue Cross Blue Shield organization.

Section 501(m) has been the subject of much debate since its enactment in the Tax Reform Act of 1986. At long last, during 2003 the IRS requested comments regarding section 501(m) from interested parties. The regulations that are forthcoming from the IRS may assist in determining the tax exempt status (or lack thereof) of HMOs and other insurers.

In addition, several judicial decisions adverse to the Plans were also released in 2003.

## Plan conversions

In the Tax Reform Act of 1986, Blue Cross Blue Shield entities became taxable entities, and section 501(m) was created to give tax exempt status to health maintenance organizations. Nevertheless, the Blues remained non-profit entities whose principal purpose was to "provide affordable and accessible health insurance" to enrollees and "assist and support public and private health care initiatives for individuals without health insurance." [91]

In the 1990s some Blues plans sought to convert to for-profit from non-profit entities as a way to raise capital. Those early conversions met little opposition from state officials. However, as Blues have regained members and financial health, state and consumer representatives have become more adverse to conversions, denying those that they believe are not in the best interests of the state and its citizens.[92] Furthermore, the IRS has recently revoked several rulings regarding the deductibility of payments that states required to be made when the Blues converted to for-profit status. As such, the tax character and deductibility of such payments remains unclear. For numerous reasons, primarily regulatory, all recently-proposed Blue Cross Blue Shield conversion plans have been terminated or stalled indefinitely.

[91] From CareFirst Blue Cross Blue Shield mission statement as reported in "Competitors could see impact from failed conversion attempts by Blues plans," Managed Care Week, July 14, 2003, Volume 13; Issue 24.

[92] M. William Salganik, "The Muscle Behind The Blues: The Blue Cross and Blue Shield Association operates with several powerful advantages," The Baltimore Sun, Aug. 10, 2003, 1D.

**BLUE CROSS BLUE SHIELD ORGANIZATIONS WITH CONVERSION PLANS:**

**Kansas:**

*Blue Cross Blue Shield of Kansas had agreed to be acquired by Anthem Insurance Companies. The Department of Insurance (DOI) rejected the proposal but was overturned by a lower court. That ruling was overturned by the Kansas Supreme Court.*

**Maryland, Washington D. C., and Delaware:**

*CareFirst faced sharp opposition from a variety of sources, including the DOI governing all three jurisdictions. Regulators determined that the conversion was not in the best interest of the state and the conversion attempt was terminated.*

**North Carolina:**

*Faced with opposition from consumer advocates, legislators, and the DOI, it decided to withdraw its conversion plan.*

**Washington and Alaska:**

*Premera is in the preliminary stages of a proposed conversion and seems to be facing similar challenges with the DOI, which is indicating that the conversion plan may not be in the best interest of the state. No final decision has been issued.*

## Cases and rulings

### Blue Cross and Blue Shield of Texas, Inc. and Subsidiaries v. Commissioner of Internal Revenue [93]

The 5th Circuit Court of Appeals affirmed the Tax Court ruling in *Blue Cross and Blue Shield of Texas, Inc. and Subsidiaries (BCBST) v. Commissioner of Internal Revenue*, that coordination of benefit (COB)

[93] *Blue Cross and Blue Shield of Texas, Inc. and Subsidiaries v. Commissioner of Internal Revenue* No. 02-60188 (16 Apr 2003).

savings using the "pursue and pay" method between health insurance companies would not qualify as a special deduction for estimated salvage recoverable under the Omnibus Budget Reconciliation Act of 1990 (OBRA). In addition, these "special" deductions would not be allowed under the safe harbor rule of Treas. Reg. Sec. 1.832-4(f)(2).

Two methods are used to account for coordination of benefit liabilities: the "pursue-and-pay" method and the "pay-and-pursue" method. BCBST used the "pursue-and-pay" approach. As a "pursue-and-pay" company, BCBST subtracted COB savings from its unpaid loss calculations. It only kept reserves on the estimated primary and secondary amounts due after the primary insurers had made their payments. No reserves were kept on the COB savings.

In 1990, BCBST included in its consolidated return a special one-time deduction for companies that had previously netted their loss reserves with salvage recoverable. The IRS disallowed the deduction and argued that the COB savings were not salvage because BCBST never expected to pay the amounts and never acquired a fixed and genuine right of recovery. BCBST filed a petition in the Tax Court, which ruled in favor of the IRS. BCBST appealed that ruling. The Appeals Court ruled against the taxpayer on two issues, whether the COB savings were salvage and whether BCBST was eligible for safe harbor protection.

### *Estimated salvage recoverable*

The Appeals Court found that BCBST's argument that its dual liability gave it a salvage right ignored the standard set forth for unpaid losses. Even if BCBST was potentially liable for the full amount, the full amount of the claim would not be a fair and reasonable estimate of its unpaid losses, because based on BCBST's experience of using the pursue and pay approach, BCBST expected that it would only have to pay the amount left over after payment by the primary plan.

### *Safe harbor provision*

BCBST then argued that it was entitled to the deduction under the safe harbor provision even if COB savings did not qualify as estimated salvage recoverable because BCBST was in good faith and acted without fraud. The Court concluded that it was not clear that BCBST fulfilled the purpose of the requirements; that BCBST's calculation of its estimated salvage recoverable did not reflect "bona fide" salvage recoverable; and that BCBST's disclosure of that calculation would not satisfy the disclosure required for safe harbor relief.

In its decision, the Appeals Court followed the Tax Court and took a form-over-substance approach. Although both COB methods yield the same result, the Court ignored that fact. The Court's analysis of the safe harbor is also troubling as a taxpayer is left to wonder when a safe harbor is truly "safe." The Court appears to be saying that if the deduction does not qualify, a taxpayer is not entitled to use the safe harbor.

## Blue Cross Blue Shield of Wisconsin v. Commissioner [94]

The Federal Court of Claims ruled that Blue Cross Blue Shield of Wisconsin (BCW) must use the actuarial estimate of unpaid loss reserves as of December 31, 1986, as reported on its annual statement to calculate the section 832(c)(4) deduction for tax year 1987.

BCW came under audit for its 1985 tax returns. Ultimately, a settlement was reached, which included a Closing Agreement provision that BCW would be considered tax-exempt during 1985 and 1986. In 1987, BCW again came under audit and received a Closing Agreement. In 1993, BCW filed an amended Form 1120 for 1987. According to BCW, the second Closing Agreement required BCW to use its "actual claims paid data," in lieu of the actuarial estimate that appears on the 1986 Annual Statement, to compute its "opening 1987 unpaid loss reserve." The IRS determined that BCW could not establish its loss reserve for unpaid claims as of December 31, 1986 "in accordance with actual claims paid data."

[94] *Blue Cross & Blue Shield United of Wisconsin v. U.S.* 56 Fed.Cl. 697. June 12, 2003.

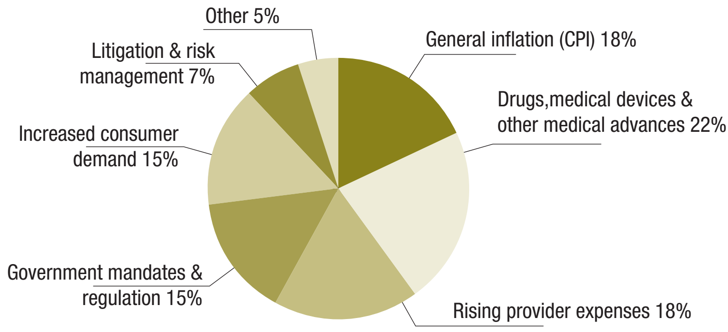
When BCW's claim for 1987 was denied, BCW filed a claim in court arguing that under section 833, the code section providing transitional guidance for Blue Cross or Blue Shield organizations becoming taxable entities, it was required to employ its actual claims paid data for 1987 to compute its opening 1987 loss reserve. The Court disagreed, finding that sections 832(b)(5) and 846 plainly show that BCW is required to employ the estimate for unpaid losses that appears on its annual statement.

BCW also argued that the Closing Agreement required it to determine its loss reserve for unpaid claims as of December 31, 1986 in accordance with actual claims paid data for 1987. However, relying on extrinsic evidence, the Court found that the IRS did not agree to any matter pertaining to BCW's section 832(c)(4) deduction for tax year 1987 in the Closing Agreement, even though the Closing Agreement seems to clearly require the use of actual claims paid data.

The case raises the question of when a closing agreement is truly "set in stone." It also points out the need for the closing agreement to be absolutely clear, as in this case the judge appears to come to a conclusion that is at odds with what the taxpayer believed the agreement covered. This case has been appealed by BCW.

## Health-care inflation grows

### Factors that drive health care costs (2001-2002)




*Source:* Prepared by PricewaterhouseCoopers from publicity available information "Health-Care Inflation Grows," BestWeek, Dec. 30, 2002, 8.

## PLR 200317019[95]

Parent, a nonprofit nonstock public benefit corporation owns Sub A, a wholly-owned, for-profit subsidiary. Sub A wholly owns several other subsidiaries. Parent converted to a for-profit stock corporation by organizing a new for-profit parent.

State A requires that, on its conversion from a non-profit to a for-profit entity, Parent dedicate a certain percent of its value to Entity A, a section 501(c)(3) organization, and Entity B whose value is irrevocably dedicated for public purposes. Therefore Parent moved the new parent's stock to the two required entities in exchange for its stock, merging and liquidating some of its subs, and transferring its assets and liabilities to the new parent. The new parent then sold its stock in an initial public offering.

The IRS ruled that the conversion to a for-profit stock corporation qualified as a tax-free recapitalization under section 368(a)(1)(E). In the ruling, no opinion was requested and no opinion was expressed or implied concerning whether the transaction involved a material change in the taxpayer's operations or its structure under section 833(c)(2)(C). In the past the IRS has been reluctant to discuss material change consequences of a conversion transaction, and has been wary, at best, in providing material change guidance of any sort. The IRS has continued its avoidance stance in PLR 200317019 by neither requesting any representation on material change nor providing any conclusions regarding the conversion transaction and material change.

[95] PLR 200317019 (April 25, 2003).

# Insurance products

chapter 9

Continuing in the trend from the past several years, both corporate-owned life insurance ("COLI") and split-dollar life insurance received negative press and adverse rulings from the courts and the IRS during 2003. The Sixth Circuit Court of Appeals found that American Electric Power's COLI plan as a whole was an economic sham. And the IRS issued exacting final split-dollar regulations. However, the industry won its first COLI case when the U.S. District Court ruled against the government in Dow Chemical, finding that Dow's COLI plans were not shams in fact or in substance. Until Dow's win, the IRS had won every COLI case it tried, including *Winn Dixie, Camelot Music*, and *AEP*.

The area that drew the most rulings during the year was variable life and annuity contracts. The IRS issued proposed regulations under section 817(h) and several rulings addressing separate accounts, including two Revenue Rulings, a Private Letter Ruling, and a Technical Advice Memorandum. The IRS also took close looks at exchanges of annuities, issuing two Revenue Rulings, a Notice involving proposed regulations on the tax treatment of tax-free exchanges, and two Private Letter Rulings regarding the tax treatment of certain exchanges of annuities.

In addition, the IRS issued a Private Letter Ruling concluding that service contracts are insurance and a Technical Advice Memorandum on the capitalization of certain costs in connection with section 848.

# Corporate-owned life insurance

## Dow Chemical [96]

The U.S. District Court, Eastern District of Michigan, ruled that the IRS improperly disallowed Dow Chemical's deductions for interest claimed on Dow's tax returns in connection with its corporate owned life insurance plans purchased to provide a source of funding for unfunded future retiree medical obligations.

The government alleged that the COLI plans were shams in substance and that the use of netting transactions were shams in fact. The government also contended that the COLI policies were not "life insurance" because Dow did not have an insurable interest under Michigan law. After examining Dow's policies, testimony, and evidence produced at trial, the Court found four areas that distinguished Dow's COLI policies from those of *AEP*, *Camelot Music*, and *Winn Dixie*.

### *Positive cash flow*

The Court found that Dow, in making its decision to purchase the policies, relied on pre-purchase illustrations demonstrating a positive plan cash flow even without the tax deduction for policy loan interest. Even though the loan illustrations demonstrated negative pre-tax cash flow in the first eighteen years, the Court evaluated the transaction as a whole and found that "Positive pre-tax cash flows delayed for eighteen years… does not render the transaction economically empty."

### *Limited loans*

Moreover, the Court found that Dow's strategy to cap loans at $50,000 and withdraw only to basis was more consistent with Dow's stated purpose of funding retiree medical expenses: the capped loan strategy produced higher positive cash flow to fund retiree medical costs. Further, it yielded more favorable financial performance in years after year 18 of the plan.

[96] *Dow Chemical Co. and Subsidiaries v. U.S.* 250 F.Supp.2d 748 E.D.Mich.,2003.

### *Inside build-up*

The Court determined, that "over the life of the plan, Dow stood to realize substantial economic gain from tax-free inside build-up returned in the form of death benefits."

### *Loading dividends*

Although the Court rejected the government's comparison of Dow's partial withdrawals with the loading dividends in the prior cases, it nevertheless found that the partial withdrawals made by Dow were factual shams. But, even though the Court found that that the partial withdrawals were shams in fact, the Court ruled that Dow met the safe harbor rule of section 264.

*Six months after the initial decision, the Court granted an IRS motion seeking amendment of the Court's rule on the loading dividends. In its motion to reconsider, the IRS argued that the Court failed to rule upon the consequences that logically flowed from the Court's determination that partial withdrawals were factual shams. In its reconsideration, the Court dismissed the IRS's argument that because payments for policy premiums were accomplished through a series of circular netting transactions, they did not actually occur. Rather, the Court ruled that its previous conclusion that the partial withdrawals were shams in fact was not correct and vacated that portion of the opinion. In finding that the partial withdrawals were not shams in fact, the reconsideration materially strengthened Dow's position. In their reply to the IRS, the Court specifically pointed to the testimony of PricewaterhouseCoopers director Irving Plotkin, stating that it was "both credible and reliable."*

The Court also found that Dow had an insurable interest under Michigan law in the lives of all of the employees and that the plans satisfied the definition of "insurance" under state law.

Many of these issues were thoroughly litigated in three prior cases, *American Electric Power*[97],*Camelot Music*[98], and *Winn-Dixie*[99], in which the courts found that the broad-based COLI plans constituted shams in substance.

The Dow case is the only COLI case that has been decided in favor of the taxpayer. It appears that this taxpayer victory may be explained, in part, by the preponderance of evidence introduced by Dow. That evidence demonstrated that Dow created a COLI task force, examined all aspects of the transaction, including but not exclusively the tax deductions, and made reasoned decisions based on its deliberative process. Thus, in its opinion, the District Court makes the point that although, from a subjective standpoint, tax deductions were discussed and considered, focus on the tax deductions themselves did not predominate. In this respect, this case differs markedly from the prior COLI cases in which the marketing information showed that, absent tax deductions, the plan would lose money.

### *American Electric Power*[100]

In contrast to the District Court decision in Dow, the Sixth Circuit Court of Appeals ruled that American Electric Power's corporate owned life insurance program was an economic sham.

In February 2001, the District Court granted judgment in favor of the United States. The court determined that the COLI plan was an economic sham. It also held that the dividends in the fourth through seventh years of the plan were shams in fact. AEP appealed to the Sixth Circuit Court.

In reviewing the case, the Circuit Court noted that AEP's COLI plan "on its face fits neatly within the 4-of-7 safe harbor rule." Only in the first three years of the plan were premiums financed through policy loans. And because the premiums were fixed at $16,667, the policy

[97] *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762 (S.D. Ohio 2001).

[98] *In re CM Holdings, Inc.*, 254 B.R. 578 (D. Del. 2000), *aff'd* 301 F.3d 96 (3d Cir. 2002).

[99] *Winn-Dixie Stores, Inc., v. Commissioner of Internal Revenue*, 113 T.C. 254 (1999).

[100] *American Elec. Power. Co., Inc. v. U.S.* 326 F.3d 737 C.A.6 (Ohio),2003. April 28, 2003.

loans through the first three years were precisely matched to the $50,000 of indebtedness on which interest was deductible. However, the Court found that when nothing of substance is to be realized beyond a tax deduction, the deduction is not allowed despite the transaction's formal compliance with Code provisions.

The Circuit Court concluded that the COLI plan as a whole was an economic sham. However, following the Third Circuit ruling in Camelot Music, the Circuit Court found that the correctness of the District Court's sham-in-fact analysis was "far from clear" and that it had "extended the factual-sham doctrine beyond its generally accepted definition."

> *At a November 5 D.C. Bar Association luncheon in Washington, Michael Doran, acting Treasury deputy benefits counsel, said of the final split-dollar regulations, "We intend for these rules to ensure that people don't use equity split-dollar essentially to provide tax-free incentives to executives. We wanted… to provide clear rules and to make sure that those tax rules really line up with what's going on in the compensatory relationship."*
>
> J. Christine Harris, *Treasury Official Discloses Final Split-Dollar Regs, Related Issues*, Tax Analysts 2003 TNT 215-4.

## Split-dollar life insurance

### Final split-dollar regulations[101]

The final regulations are substantially similar to the temporary regulations published in July 2002. The regulations apply to all new arrangements entered into on or after September 17, 2003 and to existing arrangements that are materially modified on or after that date.

Under the final regulations, a split-dollar arrangement is any arrangement between an owner and a non-owner of a life insurance contract where (a) either party pays any portion of the premiums, (b) at least one party is

[101] TD 9092.

entitled to recover premiums and the recovery is made from the proceeds of the contract, and **(c)** the arrangement is not group-term life insurance. The final regulations establish two mutually exclusive regimes: the economic benefit regime and the loan regime. The owner of the life insurance policy determines which regime applies.

If the owner of the policy is the employer, the economic benefit regime applies. The employee must recognize income for all economic benefits that are provided to the employee under the arrangements. Under the regulations, if creditors of the employer do not have access to the policy cash value, then the employee is treated as having current access to that cash value and has current income equal to that cash value less the premiums due back to the employer and less any amount of cash value previously taxed to the employee.

*Two months after the publication of the final split-dollar regulations, the IRS released corrections to nine typographical and punctuation errors in the regulations as published. The corrections did not alter the substance of the regulations. For example, a change was made to section 1.61-22(h), Example 4., paragraph (ii), line 3,where the language, "the arrangement during in each such year." was corrected to read "the arrangement in each such year."*

If the owner of the policy is the employee, the loan regime applies. Each premium payment made by the employer is treated as a loan from the employer to the employee. The regulations treat as demand loans any split-dollar loan that is payable in full at any time on the demand of the lender. All other loans are treated as term loans.

The IRS previously issued Notice 2002-8 which included two safe harbors that expired on December 31, 2003. Most companies focused on that date as the key date for making final decisions regarding split-dollar arrangements and were surprised to find that given the immediate effective date of the regulations, if any material modifications to the arrangement were made (such as switching ownership of the policy from the employee to the employer to address Sarbanes-Oxley concerns) then the *final regulations applied*.

# Variable life contracts

## Variable life insurance regulations[102]

The IRS released proposed regulations under section 817(h) which propose removing provisions of the Income Tax Regulations that apply a look-through rule to assets of a nonregistered partnership for purposes of satisfying the diversification requirements of section 817(h). The IRS believes that removal of these provisions will eliminate any possible confusion regarding the prohibition on ownership of interests by the public in a nonregistered partnership funding a variable contract.

The proposed amendments would remove Treas. Reg. section 1.817-5(f)(2)(ii), which requires taxpayers to look through an interest in a nonregistered partnership to determine whether a segregated asset account supporting a variable contract is adequately diversified. Look through treatment will be available for interests in a nonregistered partnership if: (a) all the beneficial interests in the nonregistered partnership are held by one or more segregated asset accounts of one or more insurance companies; and (b) public access to such nonregistered partnership is available exclusively through the purchase of a variable contract.

## Rev. Rul. 2003-91[103]

IC, a life insurance company, offers variable life or annuity contracts and maintains a separate account for the assets funding the Contracts. Interests in the Sub-accounts under the separate accounts are not available for sale to the public. Holders specify the allocation of premium paid

[102] 68 Fed. Reg. 163974-02 (July 30, 2003)

[103] Rev. Rul. 2003-91 2003-33 I.R.B. 347.

among the Sub-accounts. Holders may change the allocation of premiums at any time, but cannot select or recommend particular investments or investment strategies.

The IRS determined that the investment strategies of the Sub-accounts are sufficiently broad to prevent Holder from making particular investment decisions. Therefore, Holder does not possess sufficient incidents of ownership over the assets supporting either life insurance contracts or annuities to be deemed the owner of the assets for federal income tax purposes and any income derived from the assets that fund the variable contract is not included in the holder's gross income in the year in which it is earned.

In its technical analysis, the ruling offers nothing new. However, it is noteworthy as a factual matter that there were no more than 20 sub-accounts and only a once-a-month reallocation was permitted. Companies with products that operate far outside those parameters may wish to seek further guidance.

### Rev. Rul. 2003-92[104]

The Rev. Rul. addresses two situations in which a life insurance company has developed variable life insurance and annuity contracts for sale only to qualified purchasers. In a third situation Partnership interests are available only through purchase of an Annuity, life insurance contract, or other variable contract. The assets supporting the Annuity are held in segregated asset accounts and sub-accounts. At the time of purchase, Contract Holder specifies the premium allocation and may change the allocation at any time. Each Sub-account invests in partnership interests.

The IRS determined that the holder of a variable annuity or life insurance contract will be considered to be the owner of partnership interests that fund the variable contract if interests in the partnerships are available for

[104] Rev. Rul. 2003-92 2003-33 I.R.B. 347.

purchase by the general public. In Situations 1 and 2, Sub-accounts hold interests in Partnerships available for purchase *other than* by purchasers of Annuities, and Life Insurance Contracts. Therefore, *Contract Holder* is the owner of the interests in Partnerships and must include in its gross income any income derived from the Partnership interests in the year in which it is earned.

In Situation 3, Sub-accounts hold interests in Partnerships available for purchase only by a purchaser of an Annuity or a life insurance contract. Therefore, *Insurance Company* owns the interests in Partnerships that fund the Sub-accounts.

> *In a series of generally misunderstood pronouncements and actions during late July 2003, the IRS issued two revenue rulings and a proposed regulation that give tax practitioners and insurance companies guidance on how to properly (from the Service's perspective) structure hedge fund investments within variable life insurance and variable annuity contracts. As a practical matter, there is nothing the Service said or did in these actions that will likely have any negative impact on this insurance industry, as most of the business structured during the past year has been structured in compliance with these actions even before the rulings and notice were issued.*
>
> David S. Neufeld, *New Guidance on Investor Control Rule: Road Map or Road Block?*, Tax Analysts, 2003 TNT 170-29.

## PLR 200308032[105]

Company issues nonparticipating variable and fixed life insurance and annuity contracts. In response to increased interest in top hat deferred compensation plans for tax-exempt organizations, Company would like to create plans that would include plan investments in

[105] PLR 200308032 (Feb 21, 2003).

institutional mutual funds that are not publicly available. These options would include certain Non-Public Funds that are available solely through the purchase of a Variable Contract or through purchase by qualified pension or retirement plans.

The IRS ruled that satisfaction of the look-through rule of Treas. Reg. section 1.817-5(f)(2)(i) will not be prevented by reason of beneficial interests in the Non-Public Funds being held by an eligible deferred compensation plan within the meaning of section 457(b).

## TAM 200330002[106]

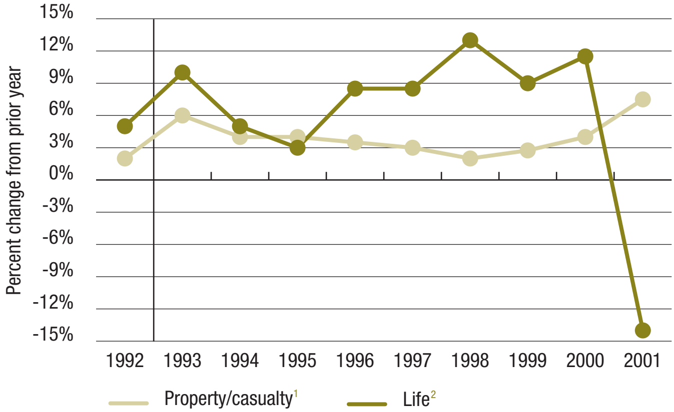
Taxpayer has a number of separate accounts used to support variable life insurance products. Each account is invested exclusively in shares of underlying mutual funds. The mutual funds are regulated investment companies (RICs).

All income, gains and losses of the separate accounts are directly attributed to the accounts of policyholders. Although the life insurance company owns the assets in the segregated asset account, the policyholder assumes the risk. In computing the gross income and reserve deductions attributable to its segregated asset accounts, Taxpayer excludes all capital gain dividends from the RIC. The examining agent disagreed with the presentation.

The IRS pointed out that, while the segregated asset accounts are taxed as part of the life insurance company, the Life Insurance RICs are taxed under Subchapter M. Under Subchapter M, all dividends distributed by a Life Insurance RIC, other than capital gain dividends, are included in a RIC's deduction for dividends paid, and are taxed as ordinary income dividends. Thus, Life Insurance RIC dividends are ordinary dividends when received by RIC shareholders and Taxpayer cannot characterize the dividends distributed by the Life Insurance RIC to its segregated asset accounts as short-term capital gains.

[106] TAM 200330002 (July 25, 2003).

### Growth in premiums, property/casualty and life insurance, 1992-2001




[1] Net premiums written, excluding state funds.

[2] Includes premiums written for ordinary, group, credit and industrial life insurance and annuities.

*Source:* A. M. Best Company, Inc.

# Exchanges of annuities

## Rev. Rul. 2003-95 [107]

The Rev. Rul. discusses three situations where the policyholder surrenders a percentage of a life insurance contract and receives a cash distribution and where the death benefit decreases as a result.

In Situation 1, A purchased a life insurance contract with a $350,000 death benefit which meets the cash value accumulation tests of section 7702. Through the end of Year 4, A paid total premiums of $45,000. At the end of Year 4, when the cash surrender value of the contract was $60,000, A surrendered 60% of the contract and received a cash distribution of $36,000. The death benefit under the contract decreased to $140,000 as a result of the partial surrender. The net single premium was $355 per $1000 of coverage.

[107] Rev. Rul. 2003-95, 2003-33 I.R.B. 358.

Situation 2 has the same facts as Situation 1, except that the contract is a life insurance contract under the guideline premium/cash value corridor test rather than the cash value accumulation test. When the contract was issued, the guideline premium limitation was $80,500. After the partial surrender, the guideline premium limitation was $265 per $1000 of insurance coverage and the cash value corridor percentage was 185.

In Situation 3, the facts are the same as Situation 2, except that the partial surrender occurred 6 years after the issuance of the contract.

The IRS ruled as follows:

- **Situation 1:** $10,300 of the cash distribution is included in A's gross income. The remaining $25,700 of the distribution is treated as a return of a portion of A's $45,000 investment in the contract, which reduces A's investment in the contract to $19,300.
- **Situation 2:** $15,000 of the cash distribution is included in A's gross income. The remaining $21,000 of the distribution is treated as a return of a portion of A's $45,000 investment in the contract, which reduces A's investment in the contract to $24,000.
- **Situation 3:** None of the cash distribution is included in A's gross income. The entire $36,000 of the distribution is treated as a return of a portion of A's $45,000 investment in the contract, which reduces A's investment in the contract to $9,000.

## Notice 2003-51[108]

Treasury is considering whether to promulgate regulations that would prescribe the tax treatment of tax-free exchanges of annuity contracts under sections 72(e) and 1035. The Notice provides interim guidance and requests comments regarding the appropriate application of section 72(e)(11) to these transactions.

[108] Notice 2003-51, 2003-33 I.R.B. 361

Treasury is concerned that some taxpayers may enter into a partial exchange transaction to reduce or avoid the tax that would otherwise be imposed by section 72(e)(2). In particular, Treasury is considering whether regulations should provide rules for determining when a partial exchange of an annuity contract followed by the surrender of, or distributions from, either the surviving annuity contract or the new annuity contract that occur within 24 months of the date on which the partial exchange was completed should be presumed to have been entered into for tax avoidance purposes.

This notice of possible future regulations is the last in a series of rule-making that has targeted potential areas of "tax avoidance" and signals again the Treasury's determination to prevent "tax avoidance" transactions.

> *Proposed regulations would prevent taxpayers from turning otherwise taxable investments in hedge funds and other entities into tax-deferred or tax-free investments merely by purchasing the investments through a life insurance or annuity contract, the Treasury said. "Life insurance and annuity contracts serve an important function – providing death-benefit protection to the beneficiaries of an insured, and providing lifetime retirement-savings protection," Treasury Assistant Secretary for Tax Policy Pam Olson said in a statement. "Unfortunately, some individuals have used the cover of insurance or annuities for the purpose of avoiding taxes on investment income," Ms. Olson said.*
>
> *Rules to Curb Life, Annuity Pacts*, The Wall Street Journal, D2, July 30, 2003.

## PLR 200313016[109]

Taxpayer issues group annuity contracts that are "nonqualified" deferred variable annuity contracts purchased with "after-tax" money. In order to market the Contracts, Taxpayer believes that it must provide owners of the Contracts and beneficiaries with more flexible distribution options.

[109] PLR 200313016 (Mar. 28, 2003).

Specifically, in the event that the owner of the Contract dies before the Annuity Commencement Date, a beneficiary may elect the "Beneficiary Continuation Option" (BCO). Under the BCO, if the Annuity Account Value at the date of death is less than the Guaranteed Minimum Death Benefit, the Annuity Account Value will be reset to equal the Guaranteed Minimum Death Benefit. Additionally, a Continuation Beneficiary will become the distributee under the Contract and may elect one of three methods to receive its distributions.

The IRS concluded that the Taxpayer's three proposed distribution methods, satisfy section 72(s)(2) and that as long as any "excess" payments result in the permanent acceleration of the payout stream, they are permitted. Finally, the IRS determined that where payments are made to a Continuation Beneficiary, no amount will be treated as constructively received before its actual payment.

## Rev. Rul. 2003-76[110]

A owns Contract B, an annuity contract issued by Company B. A contracts with Insurance Company C to issue Contract C, a new annuity contract. A assigns 60 percent of the cash surrender value of Contract B to Company C to be used to purchase Contract C. At no time during the transaction does A have access to the cash surrender value of Contract B. No consideration other than the cash surrender value of Contract B will be paid in this transaction. The terms of Contract B are unchanged, and Contract B is not treated as newly issued.

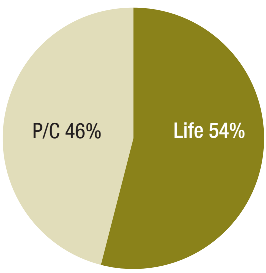
The IRS ruled that because the funds were transferred by Company B directly to Company C, A had no access to the funds during the transaction other than in the form of annuity contracts. Therefore, the transfer of a portion of Contract B to Company C for new Contract C is a tax-free exchange under section 1035. The continued existence of Contract B with its reduced cash value does not affect the tax-free exchange.

[110] Rev. Rul. 2003-76 2003-33, I.R.B. 355.

## PLR 200342003[111]

Taxpayer is a stock life insurance company. Policyholder is the sole owner and annuitant under Annuity Contract 1 issued by Taxpayer. Policyholder wishes to take an amount from Annuity Contract 1 with Taxpayer and use that amount to purchase new Annuity Contract 2 with an unrelated insurance company. Policyholder will have no personal use of the funds.

**U.S. Property/casualty and life insurance premiums, 2001**




*Source:* A.M. Best Company, Inc., Insurance Information Institute, Property & Casualty Fact Book 2003, 14.

The IRS determined that the basis of the Contract 1 needs to be allocated to its two parts immediately prior to the section 1035 exchange. The IRS gave a formula to guide Taxpayer in apportioning the original basis of Contract 1 using the relative cash values of the parts of Contract 1 immediately prior to the exchange.

The IRS ruled that the partial exchange by Policyholder of Annuity Contract 1 for Annuity Contract 2 qualifies as a tax-free exchange under section 1035, and no gain or loss is recognized on the exchange. The ruling represents another in a recent series of rulings broadening the IRS's view of the tax-free exchange of insurance policies.

111 PLR 200342003 (July 9, 2003).

# Service contracts

## PLR 200340011[112]

Parent, an automobile dealership, maintains a large parts department, service department, and body shop. Parent offers its customers extended service contracts. Parent proposes to form Taxpayer as a separate corporation, with the same ownership as Parent, for the purpose of issuing extended service contracts. Taxpayer will be the sole obligor for all extended service contracts. After collecting the contract sales price, Parent will remit a pre-determined amount to Taxpayer to cover reserve requirements and administrative fees. The balance of the contract sales price will be retained by Parent as compensation for the sale of the extended service contracts.

The IRS concluded that the extended service contracts to be issued by Taxpayer are insurance contracts, not prepaid service contracts. Further, Taxpayer qualifies as an “insurance company” for Federal tax purposes.

The ruling specifically points to possible listed transaction responsibilities under Notice 2002-70, which made PORCs listed transactions. The IRS stated that no ruling was been requested, and no opinion expressed, concerning the reinsurance arrangement and noted that certain reinsurance arrangements, as described in Notice 2002-70, are identified as “listed transactions” for purposes of the Income Tax Regulations.

# Capitalized costs

## TAM 200334005[113]

Over the past few years, in the wake of INDOPCO and the resulting capitalization craze, some companies found agents suggesting that certain new product development costs be capitalized. In most cases the issue was dropped at appeals, if not before. This TAM is the first ruling that

[113] TAM 200334005 (Aug. 22, 2003).

[112] PLR 200340011 (July 1, 2003).

addresses the issue directly, concluding on prior settled law that such costs are currently deductible.

Taxpayer, a life insurance company, historically concentrated on the sale of tax deferred fixed annuities to employees of not-for-profit institutions. These products account for a significant portion of Taxpayer's existing policy reserves. During recent years, low interest rates and strong equity returns slowed the demand for tax deferred fixed annuity products. To counteract these trends, Taxpayer expanded its products and its network of agents to increase sales of life insurance and annuity products beyond the qualified pension market.

Taxpayer incurred certain expenses related to the introduction of new insurance and annuity products, and to the expansion of Taxpayer's network of insurance agents. The expenses fall into the following categories: general overhead, actuarial services, legal and professional fees, computer expenses, promotional expenses, and educational and training expenses. On the GAAP financial statements these expenses were capitalized and amortized as start-up activities. For both annual statement and tax reporting purposes, however, Taxpayer treated the expenses as currently deductible. The IRS's examining agent disagreed with the treatment.

In its analysis, the IRS noted that legislative committee reports underlying section 848 indicate that Congress understood that a life insurance company was allowed to treat agents' commissions and other selling expenses incurred with respect to the sale of insurance policies as currently deductible business expenses and ruled that the expenses were currently deductible.

Other federal issues

chapter 10

A significant development for Health Maintenance Organizations and other insurance companies affected by sections 501(c)(3) and 501(c)(4) was the IRS' announcement that they intend to propose regulations under section 501(m) to define the term "commercial insurance." In conjunction with this announcement, the IRS announced that it is scrutinizing the tax-exempt status of entities claiming exemption under section 501(c)(15) and will challenge the exemption of any entity that does not qualify as an insurance company, regardless of whether the exemption is claimed pursuant to an existing determination letter or on a return filed with the IRS. Both announcements will have a significant effect on the insurance industry and its clients in the upcoming year.

During 2003 the IRS issued a host of administrative statements, including an updated Priority Guidance Plan; notices requesting suggestions on the Priority Guidance Plan, Form 8816, and Form 712; an Internal Revenue Bulletin updating ruling procedures; an announcement making the Fast Track Settlement Program permanent; a Revenue Ruling relating to deductions under section 847 for special estimated tax payments; and a TAM on charitable contributions of a company filing a life/non-life consolidated return.

The insurance industry lost another round in the research and development arena when the Supreme Court denied certiorari in the Eustace case. And the Federal Court of Claims ruled against negative differential earnings rates in the John Hancock case.

In addition, the IRS addressed several taxpayer requests for waivers under section 7702.

## Health maintenance organizations and tax-exempts

### Proposal to write regulations under section 501(m)

The proposal to write regulations under section 501(m) relating to commercial insurance drew comments from critics and proponents representing many segments of the insurance and healthcare industries.

Section 501(m) was enacted in 1986 specifically making Blue Cross Blue Shield Plans subject to federal income tax but leaving the status of tax exempt HMOs generally unchanged. The proposed regulations project has significant implications for the entire health plan industry and should be monitored closely. Based on clarifications of what constitutes insurance in two recent U.S. Supreme Court decisions, the industry is hopeful that the regulations project will help lead to a more consistent definition of health insurance that will be applied across all types of health carriers, including both taxable and tax-exempt organizations.

### Notice 2003-31[114]

The Treasury Department and the IRS intend to propose regulations providing guidance under section 501(m), which will define the term "commercial-type insurance" and address how section 501(m) applies

[114] Notice 2003-31, 2003-21, I.R.B. 948.

to organizations described in section 501(c)(3) and section 501(c)(4), including health maintenance organizations.

In the Notice, the IRS stated that it believes that guidance is necessary to provide section 501(c)(3) and section 501(c)(4) organizations with greater certainty as to the definition of the term “commercial-type insurance” and how section 501(m) applies to organizations described in section 501(c)(3) and section 501(c)(4), including health maintenance organizations. To date, no regulations or published guidance have been issued under section 501(m). In addition, since the enactment of section 501(m), there have been significant developments in the insurance and health care industries.

In light of the regulations project, the IRS is withdrawing the sections of the Internal Revenue Manual HMO Guidelines that relate to section 501(m).

The IRS has received many comments regarding the proposal of these regulations.

## ILM 7

As a result of Notice 2003-31, the IRS released a memorandum providing guidelines for examination and exemption application cases involving health maintenance organizations and section 501(m). The memorandum addresses the application of section 501(m) for an eighteen-month period during which the regulations are being written.

According to the memorandum the IRS will not apply section 501(m) to revoke the tax-exempt status of an HMO. Therefore, examining agents may not propose revocation of exemption of an HMO based on section 501(m), unless they have requested and received approval from the Directors of Exempt Organizations Examinations and Rulings and Agreements.

Taxpayers exempt under section 501(m) should consult with tax advisors and examine their operations to determine whether they meet the requirements for exemption under section 501(c)(3) or 501(c)(4).

*The head of the section 501(m) reg project in the IRS's Tax Exempt and Government Entities Division (TE/GE) discussed issues that have been raised in drafting the proposed 501(m) regs. He said that the HMO environment has changed dramatically since section 501(m) was enacted in 1986 and that some of the more pressing issues that the IRS will face in drafting the regulations include*

- *how the agency will determine its "perspective"–should the regs, for example, be based on the HMO industry as it existed in 1986 or as it does today, and how will the IRS write the regs so that they don't become obsolete in the future?;*
- *how to define the current "health maintenance organization";*
- *whether section 501(m) should include an overall exemption for HMOs; and*
- *whether there should be a different treatment for arranger-type HMOs versus provider-type HMOs.*

J. Christine Harris, *TE/GE's 501(m) Reg Chief Discusses Drafting Issues, Interim Rules for HMOs*, Tax Analysts, 2003 TNT 206-5.

## Notice 2003-35[115]

The IRS announced that it is scrutinizing the tax-exempt status of entities claiming exemption under section 501(c)(15) and will challenge the exemption of any entity that does not qualify as an insurance company, regardless of whether the exemption is claimed pursuant to an existing determination letter or on a return filed with the IRS.

[115] Notice 2003-35, 2003-23, I.R.B. 992.

Taxpayers should examine both the form and the substance of their "insurance" operations in light of new developments in the areas of economic substance and business purpose. Particularly, taxpayers claiming exemption pursuant to section 501(c)(15) should consider whether they are engaged in arrangements described in Notice 2002-70[116] or substantially similar thereto.

# IRS issues

## Priority guidance plan

The IRS issued the first quarterly update to the IRS "business plan" for the year ending June 30, 2004. The priority guidance plan lists tax regulations and other administrative guidance the government expects to publish by June 30, 2004.

Treasury's Office of Tax Policy and the IRS use the Guidance Priority List each year to identify and prioritize the tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices, and other published administrative guidance. The 2003-2004 Guidance Priority List sets forth guidance that the Treasury Department and the IRS intend to issue from July 1, 2003, through June 30, 2004.

Projects relating to the insurance industry include

- Guidance on cross-border insurance issues.
- Final regulations regarding taxable asset acquisitions and dispositions of insurance companies.
- Revenue ruling concerning reserves used to calculate required interest under section 812.
- Guidance regarding substantially equal periodic payments under section 72(q).

[116] Notice 2002-70, 2002-44 I.R.B. 765.

- Guidance regarding the 2001 CSO mortality tables.

The Business Plan also included several items of non-insurance company guidance in areas such as consolidations, exempt organizations, international taxation, and executive compensation.

## Notice 2003-26[117]

The IRS requested suggestions for regulations, rulings, and other administrative guidance that should be included on the 2003-2004 Guidance Priority List, referred to as the "IRS Business Plan."

## IRB 2003-1

The IRS released IRB 2003-1, containing annual updated Revenue Procedures dealing with letter rulings, determination letters, technical advice, advance rulings, information letters, etc.

- **Rev. Proc. 2003-1[118] and Rev. Proc. 2003-2[119]:** Revised procedures for issuing letter rulings, determination letters, information letters, and technical advice on specific issues under the jurisdiction of the associate chief counsel (corporate), associate chief counsel (financial institutions and products), associate chief counsel (income tax and accounting), associate chief counsel (international), associate chief counsel (passthroughs and special industries), associate chief counsel (procedure and administration), and division counsel/associate chief counsel (tax exempt and government entities).
- **Rev. Proc. 2003-3[120] and Rev. Proc. 2003-7[121]:** Listing of areas in which advance rulings will not be issued. In accordance with Rev. Proc 2002-75[122] issued late in 2002, Rev. Proc. 2003-3 does not include captive insurance arrangements in its "no rule" listing.

[117] Notice 2003-26, 2003-18, I.R.B. 1.

[118] Rev. Proc. 2003-1, 2003-1, I.R.B. 1.

[119] Rev. Proc. 2003-2, 2003-1, I.R.B. 1.

[120] Rev. Proc. 2003-3, 2003-1, I.R.B. 1.

[121] Rev. Proc. 2003-7, 2003-1, I.R.B. 1.

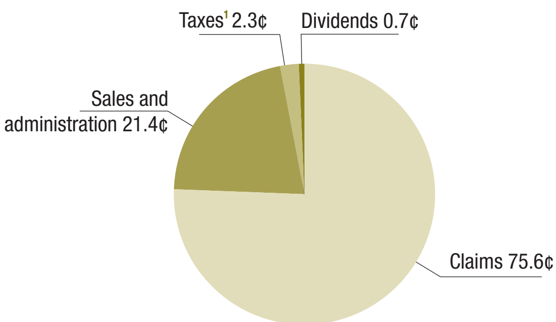
[122] Rev. Proc. 2002-75, 2002-52 I.R.B. 997.

- **Rev. Proc. 2003-4[123] and Rev. Proc. 2003-5[124]:** Revised procedures for furnishing ruling letters, information letters, and technical advice on matters under the jurisdiction of the Tax Exempt and Government Entities Division.
- **Rev. Proc. 2003-6[125]:** Revised procedures issuing determination letters on the qualified status of employee plans.

## Rev. Proc. 2003-41[126]

The IRS made the Fast Track Settlement program (FTS) for large and mid-size businesses (LMSB) permanent. The Rev. Proc. contains guidance designed to help taxpayers and the IRS reach agreement on tax disputes more quickly

**Where the premium dollar goes, property/casualty insurance, all lines, 2001**




[1]Excluding federal and foreign income and real estate taxes

*Source:* A.M. Best Company, Inc., Insurance Information Institute, Property & Casualty Fact Book 2003, 14.

[123] Rev. Proc. 2003-4, 2003-1, I.R.B. 1.

[124] Rev. Proc. 2003-5, 2003-1, I.R.B. 1.

[125] Rev. Proc. 2003-6, 2003-1, I.R.B. 1.

[126] Rev. Proc. 2003-41, 2003-25, I.R.B. 1044.

Appeals and LMSB Fast Track Program Managers will accept issues into the FTS program only if they are satisfied that the issue is sufficiently developed; however, FTS is generally available for all cases within LMSB Compliance jurisdiction. The Rev. Proc. lists several issues which are not eligible for inclusion into the FTS. It is effective June 3, 2003.

The LMSB Fast Track Dispute Resolution Pilot Program was announced in Notice 2001-67[127]. FTS is not well suited for all cases, so taxpayers must evaluate their individual circumstances to determine if the FTS program meets their needs and whether the number of issues is manageable within a 120 day time frame. The Fast Track Mediation program for small businesses and self-employed taxpayers was also made permanent.

## Comments on form 8816

The IRS solicited comments concerning Form 8816, *Special Loss Discount Account and Special Estimated Tax Payments for Insurance Companies*.

The following changes are being made to Form 8816:

1. The line items in Part I are being separated into two parts. Part I will be Unpaid Losses – Undiscounted and Discounted, and Part II will be Special Loss Discount Account. Part III will be Special Estimated Tax Payments (previously Part II).
2. The old Part III, Tax Benefit Associated with the Additional Deduction under Section 847, is being eliminated.
3. A new line is being added to Part III to request information on prior section 847 payments transferred to the current year.

## Comments on form 712

The IRS solicited comments concerning Form 712, *Life Insurance Statement*.

[127] Rev. Proc. 2001-67, 2001-

Form 712 provides taxpayers and the IRS with information to determine if insurance on the decedent's life is includible in the gross estate and to determine the value of the policy for estate and gift tax purposes. The tax is based on the value of the life insurance policy.

## Form 1120-PC changes in filing locations

Some insurance corporations may need to mail their returns to a different address, according to the 2002 instructions for Form 1120-PC.

If the corporation's principle business, office, or agency is located in the United States, the corporation should file its 2002 Form 1120-PC and extensions in Ogden, Utah. This would presumably include 953(d) companies with U.S. offices.

If the corporation's principle business, office, or agency is located in a foreign country or U.S. possession (or the corporation is claiming the possessions corporation tax credit under sections 30A and 936), the corporation should file its 2002 Form 1120-PC and extensions in Philadelphia, Pennsylvania.

There have been no changes in the Form 1120 and Form 1120L filing locations.

## Rev. Rul. 2003-34[128]

The IRS released Rev. Rul. 2003-34 ruling that if an insurance company takes a deduction under section 847 in a taxable year, the company is not required to request the permission of the Secretary or his delegate in order to discontinue using section 847 in a subsequent year.

The IRS found that section 847 imposes no requirement upon an insurance company that is required to discount its unpaid losses under section 846 to continue to avail itself of the section 847 deduction on an annual

[128] Rev. Rul. 2003-34, 2003-17, I.R.B. 813.

basis. Further, the IRS ruled that the legislative history of section 847 does not suggest that an insurance company having once used section 847 is obligated to continue to do so in subsequent tax years.

Section 847 provides surplus benefits, and not tax benefits, for federal tax purposes. The few companies that do utilize 847, do so for state tax purposes.

## Research and development

### Nicholas E. Eustace et. al. v. Commissioner of Internal Revenue[129]

The Supreme Court denied certiorari in a case concerning computer software development and research credits.

> *While bonds continued to dominate investment portfolios, compromising 66 percent of total investments in 2001, the percentage dropped from 70 percent in 1996. Investments in U.S. government bonds continue to fall fastest, falling from 17 percent of all investments in 1996 to 11 percent in 2001.*
>
> Insurance Information Institute, Property & Casualty Fact Book 2003, 21.

ASI was founded in 1980 to produce computer software for independent insurance agencies. ASI released a rating module and a program designed to automate the day-to-day functions of independent agencies. In 1992 ASI decided to adjust the programs for small agencies and made over 250 modifications to the programs. ASI did not claim the research credit on its original income tax returns but filed amended returns to claim research credits for the modifications. The IRS disallowed the credits, arguing that the ASI employees did not undertake research to discover

[129] *Nicholas E. Eustace, et al. v. Commissioner* T.C. Memo 2001-66.

information that is technological in nature. Both the Tax Court and the Appeals Court ruled for the IRS.

ASI appealed to the Supreme Court, and certiorari was denied.

# Charitable contributions deductions

### TAM 200323002[130]

Taxpayer filed a life-nonlife consolidated return and computed the consolidated charitable contribution deduction limitation by first aggregating the consolidated taxable incomes of each subgroup. Taxpayer then determined that 10% of this “consolidated modified taxable income” was the aggregate amount of charitable deductions that the group was entitled to and allocated to each subgroup a portion of the total amount of charitable deductions allowed based on the proportion of charitable contributions each subgroup made to the total charitable contributions by all members of the group. The IRS disagreed with Taxpayer’s methods.

The IRS determined that each life-nonlife subgroup should compute its own charitable contribution deduction limitation based on that subgroup’s consolidated taxable income (CTI) because Treas. Reg. section 1.1502-47(r) provides that the subgroup approach preempts any other consolidated return regulation.

While the IRS concluded that a subgroup approach was appropriate here and in all life-nonlife consolidations, the ruling is contrary to the recent *State Farm* ruling where the Tax Court determined that the book income adjustment must be made on a consolidated group basis, not a subgroup basis. In the TAM, the IRS states that this case is distinguishable from *State Farm* because the issue in *State Farm* was the appropriate manner of making the book income adjustment for AMT purposes for a life-nonlife consolidated group.

[130] Technical Advice Memorandum 200323002 (Jun. 6, 2003).

# Funding agreements

## TAM 200325001[131]

Taxpayer is a life insurance company that markets funding agreements to institutional investors. As the purchasers were not natural persons, the agreements did not contain any provisions relating to mortality or morbidity. Moreover, Taxpayer did not offer any annuity form of settlement (life or fixed term) and the agreements did not contain annuity purchase guarantees.

In its annual statement, Taxpayer reported the initial consideration for the Funding Agreements as premiums, and established a corresponding reserve item for "Deposit Funds and Other Liabilities without Life and Disability Contingencies." The change in this reserve flowed through the Summary of Operations, and Taxpayer accounted for its obligations through an increase in the related reserves established for the contracts. For federal tax purposes, Taxpayer treated the reserves as deductible section 807(c)(3) reserves.

The IRS concluded that when tested against the federal tax definition of insurance, Taxpayer's assumption of these investment risks was insufficient to create an insurance contract for tax purposes. Accordingly, the accumulated funds held by Taxpayer do not constitute a reserve item under section 807(c). Rather, Taxpayer should account for its obligation to credit guaranteed interest through the deduction allowed by sections 805(a)(8) and 163 for interest paid or accrued within the taxable year on indebtedness.

[131] TAM 200325001 (June 20, 2003).

# Differential earnings rates[132]

## John Hancock Financial Services Inc. v. U.S.[133]

The Federal Court of Claims ruled that John Hancock Life Insurance Company may not use recomputed differential earnings amounts not allowable as deductions to exclude future income.

John Hancock Life Insurance Company, formerly John Hancock Mutual Life Insurance Company, claimed that disallowance of additions to its policyholder dividend deduction relating to the negative recomputed differential earnings amount for 1986 resulted in increases in tax for 1988 and 1989. John Hancock contended that, under the tax benefit rule, it is entitled to exclude those increases because the same data used to calculate its recomputed earnings differential amount for tax year 1986, from which it obtained no tax benefit, were also used as a basis for imputing taxable income for 1988 and 1989.

> *Investments in common stock grew over the past 10 years from 16 percent in 1991 to 21 percent in 2001. Most of the growth occurred in the "industrial and miscellaneous" category, which rose from 9 percent to 13 percent.*
>
> Insurance Information Institute, Property & Casualty Fact Book 2003, 21.

The Court noted that three U.S. Courts of Appeals cases have upheld the Government's disallowance of increased policyholder dividends associated with negative recomputed differential earnings rates: *CUNA; Indianapolis Life; and American Mutual Life Ins. Co. As in American Mutual*,

[132] The Job Creation and Worker Assistance Act of 2002 amended section 809 to provide that the DER should be treated as zero for purposes of computing both the differential earnings amount and the recomputed differential earnings amount for a mutual life insurance company's taxable years beginning in 2001, 2002, or 2003. In the absence of legislation that has been proposed, but not passed, it is expected that the requirement that companies file Form 8390 will be reinstated in 2004.

[133] *John Hancock Financial Services, Inc. v. U.S.* 92 A.F.T.R.2d 2003-5304, July 15, 2003.

the Court found that John Hancock took a full policyholder dividend deduction based upon recomputed differential earnings amounts lawfully allowable in that year and as a result may not use recomputed differential earnings amounts not lawfully allowable as the basis for excluding future income. Further, application of the tax benefit rule to exclude income associated with disallowed "deductions" would contradict law that disallows any deduction based on any negative recomputed differential earnings rates calculated under section 809.

## Waivers

The IRS issued three waivers under section 7702. Two of the waivers, PLR 200320020 and PLR 200327037, were standard waivers for employee and technical error. The third waiver, PLR 200328027, involved a misinterpretation of legislative history instead of a mechanical, clerical, or technological error. The ruling is similar to PLR 200230037 and may indicate a broadening of the IRS view of what constitutes "reasonable error."

### PLR 200320020[134]

Certain of Taxpayer's participating, flexible premium universal life insurance contracts failed to comply with section 7702. Taxpayer recalculated the guideline premium limitation for policies with riders taking into account only reasonable charges that it expects to impose in accordance with section 7702(c)(3)(B)(ii) and modified its section 7702 compliance administrative system to eliminate the error.

The IRS found that the failure of the policies to satisfy the requirements of section 7702 was due to reasonable errors. In making its decision, the IRS noted that although the Code, in setting forth the guideline premium limitations, does not specifically direct taxpayers to treat certain riders under section 7702(c)(3)(B)(ii), rather than (c)(3)(B)(i), the rules applicable to the cash value accumulation test are controlling in this regard.

[134] PLR 200320020 (May 16, 2003)

### PLR 200327037[135]

Certain of Taxpayer's Contracts that are either universal life insurance contracts or variable universal life insurance contracts failed to comply with section 7702. The Contracts failed section 7702 due to one of four errors involving **(1)** removal of an alert system by an employee, **(2)** employee error in the handling of premiums received, **(3)** employee error regarding the 60-day refund period, and **(4)** a temporary manual override and data entry error.

The IRS ruled that the failure of the Contracts to satisfy the requirements of section 7702 was due to reasonable error.

### PLR 200328027[136]

Certain of Taxpayer's participating, flexible premium universal life insurance contracts failed to comply with section 7702. The failed Contracts were nonparticipating fixed premium universal life insurance contracts.

Taxpayer represented that the failure occurred because it misinterpreted the legislative history of the Deficit Reduction Act of 1984 in assuming that the Tabular Cash Value, which represented the "alternate State law minimum nonforfeiture guarantee," would always exceed the Accumulation Value. Actuaries misapplied the law because they focused on the fact that the Accumulation Value could not mature a policy rather than focusing on the factors required to be considered in determining the guideline premium limitation on a universal life policy.

The IRS determined that the failure of Contracts to satisfy the requirements of section 7702 was due to reasonable error. Although Company A erred in its application of the legislative history of the 1984 Tax Act, the errors were a possible misinterpretation of the mechanics of section 7702.

[135] PLR 200327037 (June 6, 2003).

[136] PLR 200328027 (July 11, 2003).

# Settlement payments

### TAM 200322017[137]

Taxpayer became liable for the remediation of environmental contamination and filed claims with insurance carriers to recover remediation costs associated with its environmental liabilities. The claims were associated with "commercial general liability" ("CGL") policies, which generally cover an insured's liability to third parties for torts committed by the insured. The IRS found that none of the policies provided coverage for property damage to Taxpayer's properties. Taxpayer claims that while such policies may not expressly provide such coverage, in its negotiations with the insurance companies, it asserted and settled claims against its insurers for property damage to its properties and submitted no third-party liability claims.

The IRS concluded that Taxpayer's CGL insurance policies carried no express provisions providing coverage for damage to Taxpayer's own property. Thus, the insurance settlement payments received by Taxpayer under its third-party CGL policies were monies received for indemnification with respect to tort liability and were not monies received due to an involuntary conversion within the meaning of section 1033(a)(2).

# Annual statements

### Capital gains

In an effort to make all the annual statement blanks consistent, the NAIC approved a change in the presentation of tax expense/benefit related to realized capital gains/losses on the Property & Casualty blank. Once effective, the tax impact related to realized capital gains/losses will be netted against gross realized gains or losses for purposes of presentation on the Statement of Operations (line 10, page 4 of the 2003 P/C Blank).

[137] TAM 200322017 (May 30, 2003).

The NAIC had wanted the change to be effective for 2003 and made a change to the 2003 instructions for line 19, *Federal and Foreign Taxes Incurred*, to reflect that change. However, the NAIC was not able to make necessary changes to an underlying schedule in time for 2003. Therefore, the change is now effective for 2005 quarterly and annual statements.

> *A new standard adopted by the American Institute of Certified Public Accountants requires life insurers to establish reserves to pay death benefits and other guarantees on variable annuities and variable life insurance, where clients' premiums are invested in mutual funds. The rule, effective Jan. 1, 2004 will require companies to recognize a liability for guaranteed minimum death benefits and other living benefits related to variable annuity and variable life contracts.*
>
> *A.I.G. Says Rule Change Will Cost $200 Million*, The New York Times, November 15, 2003, no page.

While the change is not effective until 2005, many companies were informed the change would be effective for 2003 and should check the NAIC's website for the revised instructions. In anticipation of the reporting change, companies should refer to paragraph 15 of SSAP 10 and section 10a of the Q&A 10 Implementation Guide, which both make reference to paragraph 38 of SFAS 109, for guidance.

## Presentation clarified

The NAIC Blanks Task Force discussed and adopted an agenda item to "Modify the quarterly blank instructions regarding the Notes to Financial Statements to reflect the disclosure requirements discussed in SSAP No. 10—Income taxes, Exhibit A Implementation Questions and Answers, Paragraph 12.24." The change was intended to make first quarter disclosures more consistent.

The agenda item proposed a change to the Quarterly Notes Instructions, and many worried that the instructions seemed to require the same disclosures for *quarterly* notes that are required to be included in the *annual* SSAP 10 tax footnote. This is not the case. The change is simply a technical correction meant to conform the Annual Statement instructions with the Q&A guidance. Accordingly, there should be no change in reporting for companies that followed the disclosure requirements set out in the SSAP No. 10 Q&A.

Multistate

# chapter 11

While the 2003 legislative sessions, in most states, did not produce many insurance premium tax changes, New York, California and Illinois provided several major provisions. Several states eliminated or suspended credits in the attempt to raise revenues due to huge budget deficits. New Mexico actually raised its premium tax rate from 3 percent to 3.003 percent.

Some of the more substantive changes at the legislative level include an overhaul of the premium tax on property and casualty companies in New York, an increase in the income tax limitation for foreign insurance companies in Illinois as well as new stiffer penalty and interest provisions, a limitation on the amount of credit that can be used against the Connecticut premium tax, premium tax rate reduction in Iowa, tax shelter legislation in California, and a change in the South Carolina premium tax base from collected to written premium. In addition, Georgia suspended its CAPCO program until January 1, 2007.

On the judicial and audit side, Idaho is being sued by an insurance company claiming the state's two-tiered insurance premium tax is unconstitutional. An Illinois Circuit Court held that gains arising from the deemed sale of assets under IRC section 338(h)(10) was business income. The Philadelphia Tax Review Board held that an Iowa-based insurance company owed the Business Privilege Tax on its rental income and gross receipts from the insurance company's real estate business because the imposition of the tax would trigger a retaliatory tax on Pennsylvania-based insurance companies in Iowa. The Texas Comptroller of Public Accounts held that bad debts or unearned premium are subject to the Texas premium tax and must be included in the taxable base.

## State-by-state developments

### Alaska

House Bill 120 excludes service contracts from regulation as insurance. It specifically relates to insurance licensing for motor vehicle service contracts and home warranties. The Act is effective July 17, 2003.

### Arizona

For purposes of claiming an enterprise zone credit against Arizona corporate income, personal income, and insurance premium taxes, a taxpayer may provide the Arizona Department of Revenue with information for employees working in a zone location by means other than a separate Form 304-1 for each employee. The information may be submitted on a hardcopy spreadsheet or by electronic media like a Microsoft Excel spreadsheet or pdf file on either a 3 1/2 inch diskette or a CD-ROM. The chosen media must be Microsoft Windows compatible. The diskette or CD-ROM must be labeled as Form 304-1 with the taxpayer's name, federal ID number, and tax year, and sent directly to the Arizona Department of Revenue, Attn: Corp. Office Audit/EZ Credits, 1600 West Monroe, Phoenix, AZ 85007. (Announcement, Arizona Department of Revenue, April 9, 2003.)

## Arkansas

> *The Alabama Supreme Court remanded to a lower court a $50 million jury verdict in favor of a Torchmark Corp. unit against mutual-fund firm Waddell & Reed Financial Inc. In July, a jury found in favor of Torchmark's United Investors Life Insurance in a dispute over variable annuity policies, which Waddell & Reed marketed. Torchmark, a financial-services holding company, was once the parent company of Waddell & Reed.*
>
> *Alabama Sends Suit By Torchmark Unit Back to Lower Court*,
> The Wall Street Journal, Apr. 22, 2003, C15.

Senate Bill 424 provides that the Insurance Commissioner may not issue a license to a producer reinsurance captive insurance company, pure captive insurance company, sponsored captive insurance company, association captive insurance company incorporated as a stock insurer, or industrial insured captive insurance company incorporated as a stock insurer, unless the company possesses and maintains unimpaired paid-in capital of: $300,000 for a producer reinsurance captive insurance company, $100,000 for a pure captive insurance company, $400,000 for an association captive insurance company incorporated as a stock insurer, $200,000 for an industrial insured captive insurance company as a stock insurer, $500,000 for a sponsored captive insurance company and $300,000 for a special purpose captive insurance company.

## California

Assembly Bill 1601 and Senate Bill 614 require taxpayers to disclose "reportable transactions" on their California tax returns. Likewise, promoters will be required to register and maintain lists of investors. This legislation creates a comprehensive set of changes that increase the penalties for investors, promoters, and organizers of abusive tax shelters; enhances the Franchise Tax Board's (FTB's) ability to pursue investors, promoters, and organizers of abusive tax shelters; and establishes a limited window of time during which taxpayers who voluntarily pay all tax and interest due can avoid the enhanced penalties. Generally, the non-penalty provisions are effective January 1, 2004. Generally, the penalty provisions are effective for any penalty assessed on or after January 1, 2004, on any return for which the statute of limitations on assessments has not expired. There are many exceptions to the general effective dates.

In the Matter of the Petitions of Wausau Business Insurance Company, California State Board of Equalization, December 18, 2002, the California State Board of Equalization unanimously overruled the Department of Insurance ("DOI") and held that DOI's attempt to collect retroactive premium taxes on amounts reimbursed to insurers from employers under high-deductible workers' compensation policies was invalid.

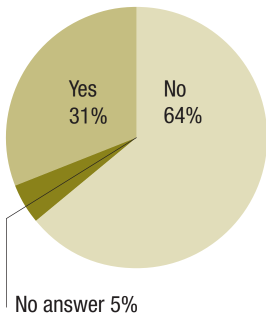
Insurers in California writing workers' compensation policies with deductibles are subject to premium tax on deductible amounts received from insured employers under a notice issued by the California Department of Insurance that classifies deductible amounts as gross premiums for tax years 1997 and forward. (California Department of Insurance, Notice, 2/25/2002). Companies appealed the notice to the State Board of Equalization ("SBE"). In December of 2002 (see Wausau case above), the SBE overruled the Department of Insurance. Recently, the new Insurance Commissioner, John Garamendi, announced that he will not seek to appeal the SBE's decision.

## Judgement day

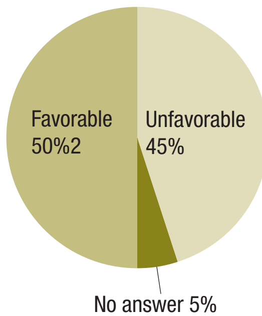
Exit polls showed that Californians' negative view of their economy outweighed concerns over Arnold Schwarzenegger's campaign.

### On Arnold

Did Mr. Schwarzenegger address the issues in enough detail?

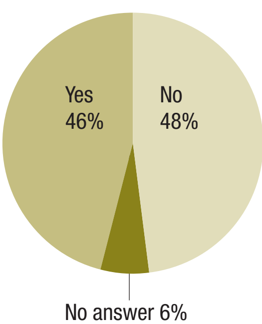



What is your opinion of Mr. Schwarzenegger?

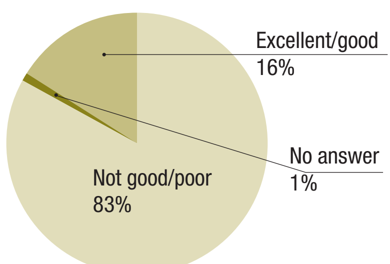



### On the economy

Will California be able to resolve its budget deficit without raising taxes?




What is the condition of California's economy?




*Source:* Survey of 4,172 voters conducted by Edison Media and Mitofsky International, *The Wall Street Journal*, Oct. 9, 2003, A1.

## Connecticut

House Bill 6802 limits the amount of credit an insurance company can take against its insurance premium tax. Insurers are disallowed from eliminating their entire tax liability through the use of tax credits. The bill limits the reduction of tax liability to 70% by using the credits. This limitation now being imposed on insurers is already imposed on other regular corporate taxpayers. The Bill is effective for tax years beginning on or after January 1, 2003.

## Florida

Credits against Florida insurance premium taxes for investments in a certified capital company pursuant to the second Florida Certified Capital Company (CAPCO) Program may not be taken until the certified investor files its 2003 insurance premium tax return, due March 1, 2004. However, assuming the allocation of the program credits and the certified investment are made by December 31, 2003; the certified investor bases all installments on 27% of the preceding year's net tax due; and there are no adjustments made to the timing for the program credits, the certified investor would not be able to begin claiming the credits until its October 15, 2004 installment payment. The investor's April 15, 2004 and June 15, 2004 installment payments would be computed as if the investor did not receive the credit in order to compute the 27% exception for those installments. Technical Assistance Advisement, No. 03B8-001, Florida Department of Revenue, February 10, 2003.

## Georgia

House Bill 43 delays, from July 1, 2005 to January 1, 2007, the ability of insurance companies to utilize CAPCO premium tax credits.

> *John Oxendine, insurance commissioner for the Georgia Department of Insurance in Atlanta, said the state's major concern is medical malpractice, "and we are working to try to address that." He said the Senate passed some civil litigation reform this year that is still pending in the House and will carry over into next year's session. The legislation would limit non-compensatory damages and also would make "forum-shopping a little more difficult-where you pick your judge and your county to find a favorable climate," he said.*
>
> Caroline MacDonald, *Issues Vary For Regs In Four Large States*, National Underwriter, June 17, 2003, no page.

## Idaho

House Bill 327 amends existing law to provide that the formation of mutual insurance holding companies should not increase the tax burden of the mutual insurance holding company system; to provide that dividends or distributions may be issued by a stock insurance subsidiary to the mutual insurance holding company or intermediate holding company; and to provide that such dividends or distributions shall be excluded from Idaho taxable income in certain circumstances.

A Boise-based insurance company is suing Idaho, seeking to get the state's two-tiered insurance premium tax declared in violation of the U.S. and Idaho constitutions. Idaho's insurance premium tax rate is 2.75 percent, the nation's seventh highest rate, but that rate is discounted to 1.4 percent for companies that invest at least one-quarter of their assets in qualifying Idaho investments. Plaintiff contends that Idaho's two-tiered premium tax structure, which imposes a 2.75 percent premium tax rate on the Plaintiff and which results in a minimum rate of 2.75 percent for all business conducted by Plaintiff in other states, is without rational basis. *General Fire & Casualty Co. v. Idaho State Tax Commission*, November 19, 2002.

## Indiana

The Indiana Department of Revenue ("Department") published Letter of Findings ("LOF") 02-0304. In its LOF, the Department determined that a captive insurance company structure of an Indiana taxpayer lacked business substance and was in fact a "sham" created solely for purposes of tax evasion even though the same taxpayer's transaction was not a sham for federal income tax purposes. Upon the determination by the Department, the Department was unwilling to adjust its audit assessment levied against the taxpayer. The assessment required the taxpayer to reallocate premiums paid to the captive as well as the income of the captive insurance company back to the payor of the premiums. Supplemental Letter of Findings, No. 02-0304SLOF, October 1, 2003.

## Illinois

Senate Bill 1634 raises the floor below which foreign insurers' tax may not be reduced, from 1.25% of certain items, to 1.75% of certain items, for taxable years ending on or after December 31, 2003. (Modifying 35 ILCS 5/201(d-1)(1)(B))

Senate Bill 1903 increases two filing fees applicable to captive insurance companies: the fee for incorporating is increased from $3,500 to $7,000 and the fee for filing requests to change the plan of operations is increased from $100 to $200. (Amending 215 ILCS 5/123C-17). The bill also increases the annual financial regulation fees for companies doing an insurance business in Illinois (Amending 215 ILCS 5/408(6) and (7)) and increases the penalty imposed on insurance companies for failing to file a tax return. (Amending 215 ILCS 5/412(d)(2).)

Senate Bill 969 provided for an amnesty for taxes under the Department of Revenue.

The Cook County Circuit Court held that gains arising from the deemed sale of assets of a taxpayer and its deemed liquidation pursuant to IRC section 338(h)(10) and the subsequent distribution of the proceeds to a shareholder (selling group) of the taxpayer's parent was business income apportionable to Illinois for Illinois corporate income tax purposes under the functional analysis test. Since the assets were transferred to the selling group before the taxpayer's business operations ceased, the Court held that the gains from the deemed asset sale were apportionable business income. *American States Ins. vs. Illinois Dept of Revenue*, (No. 01L50940), October 29, 2002.

The Circuit Court of Cook County, Ill., denied a taxpayer's motion to reconsider its original judgment upholding the Illinois Department of Revenue's determination that a captive insurance company was not an insurance company for purposes of the Illinois Income Tax Act. *Armstrong World Industries Inc. v. Glen Bower*, (No. 00L50705), February 11, 2003.

An Illinois Department of Revenue administrative law judge ("ALJ") has ruled that the income tax carryback period for insurance companies is two years, despite a three-year federal period for life insurance companies. Taxpayer, a life insurer, had argued that Illinois should look to the life insurance NOL carryback provision in IRC section 810 which allowed for a three year carryback for 1998, the year at issue. The ALJ, agreeing with the Illinois Department of Revenue, found that the Illinois NOL provision provides that the NOL must be carried back in the manner allowed under IRC section 172, which in 1998 provided for a two-year carryback. Thus, because the statute was clear and absent legislative change, the ALJ found that the NOL carryback had to follow the provisions of IRC section 172. *Department of Revenue v. ABC Reinsurance Co.*, IT 03-2, Feb. 3, 2003.

## Iowa

Senate File 458 reduces the rate of the gross premium tax, applicable to mutual insurance associations, from two percent (2%) to one percent (1%) for the following calendar years: before 2003, 2%; 2003, 1¾%; 2004, 1½%; 2005, 1¼%; 2006 and thereafter, 1%. The bill requires prepayments and additional prepayments for mutual insurance associations whose Iowa premium tax liability for the preceding calendar year was one thousand dollars ($1,000) or more, and allows such prepayments as a credit against current year tax.

Senate File 441 amends Iowa insurance premium tax provisions related to the historic property rehabilitation tax credit and the enterprise zone investment credit for eligible housing businesses. For tax years beginning after 2002, historic property rehabilitation tax credits meeting certain requirements may be transferred to any person or entity.

The Iowa Capital Investment Board has adopted new rules concerning investment tax credits against Iowa insurance premium taxes. A taxpayer may claim a credit for an investment in an Iowa fund of funds organized by the Iowa Capital Investment Corporation. Excess credits may be carried forward for seven calendar years. (Rules 123-4.1(15E)-4.16(15E), Iowa Capital Investment Board, effective July 3, 2003.)

## Louisiana

The Louisiana Department of Revenue has announced that it will not acquiesce in the decision reached by the Louisiana Court of Appeals for the First Circuit in Louisiana Health Services and Indemnity Co., d/b/a Blue Cross and Blue Shield of Louisiana, 746 So.2d 285 (1999). In that case, the court ruled that the taxpayer, a health insurer that purchased mass-produced advertising materials that were subsequently delivered through the mail to its potential customers, was not subject to Louisiana sales and use tax on its purchase of the materials. The statute at issue, section 47:302 (D), La. R.S., provides that a transfer of mass produced advertising items by an advertising business to a client constitutes a taxable sale when the transfer involves the furnishing of minimal services other than manufacturing services. The court interpreted this provision to require an actual transfer of physical possession of the mass-produced items to the purchaser, and concluded that, because the materials were placed in the U.S. Mail by the seller for delivery to the insurer's potential customers, the insure never took possession of the materials sufficient to subject it to tax.

## Maine

House Paper 973 amends Me. Rev. Stat. Ann. tit. 36 section 2513 to include a definition of “annuity considerations.” In addition, this bill would amend this section to state that annuity considerations received in tax years ending prior to January 1, 1999 upon which no tax was paid in the year received must be taxed in the year in which an annuity is actually purchased. Furthermore, the bill provides that when direct return premiums are returned in the same tax year that the premium was paid, the deduction allowed under Me. Rev. Stat. Ann. tit. 36 section 2515 may be taken only if the premium tax has been paid. Also, this legislation changes the beginning date of when a fire insurance company can take a credit for the special assessment paid after 7/1/2002, from years beginning on or after July 1, 2003, to years beginning on or after July 1, 2005.

Senate Paper 21 increases the assessment levels allowed on workers’ compensation insurance to fund the Workers’ Compensation Board Administrative Fund to $8,390,000 beginning in fiscal year 2003-2004, to $8,565,000 beginning in fiscal year 2004-2005, and to $8,525,000 beginning in fiscal year 2005-2006.

Senate Paper 510 establishes caps for various fees under the Maine Insurance Code and gives the superintendent the authority to adjust those fees as necessary, not to exceed the set cap amounts.

## Massachusetts

In Ace Property & Casualty Ins. Co. v. Commissioner of Revenue, 473 Mass. 241 (2002), the Supreme Judicial Court held that the Federal Crop Insurance Act, 7 U.S.C. 1501 et seq., preempts state law and prohibits states from imposing any tax on or measured by premiums from crop insurance policies that are reinsured by the Federal Crop Insurance Corporation. The result of the decision is that the Department will not impose any tax on premiums related to policies that are reinsured by the Federal Crop Insurance Corporation.

## Michigan

Senate Bill 496 requires every insurance company, association, risk retention group, or purchasing group that is not licensed under the statutes of the state to pay a fee of $10 for service in order to do business.

## Minnesota

House File 1565 and Senate File 1505 adjust the definition of "gross premiums" to include any workers' compensation Special Compensation Fund premium surcharge amount.

In *Blue Cross Blue Shield of Minnesota v. Commissioner of Revenue*, No. 7387 (Aug. 1, 2002), the Minnesota Tax Court ruled that premiums received by an insurer from employers who self-fund their employee health care benefits are not subject to premium tax. Blue Cross Blue Shield ("BCBS") sold stop-loss coverage to a number of employers that provided their employees with health insurance coverage. BCBS filed a refund claim on the basis that the stop-loss arrangement constituted a reinsurance agreement and not "direct business" subject to premium tax. The court agreed and concluded that an insurance arrangement can be classified as reinsurance even though an issuing entity of the insurance policy is not an insurance company under state law. The court looked to the substance of the transaction between the employee and employer as "direct insurance" and characterized the employer's purchase of stop-loss coverage as a reinsurance arrangement not subject to premium tax. On June 12, 2003, the Minnesota Supreme Court affirmed the Minnesota Tax Court ruling.

## Mississippi

House Bill 1366 requires state residency for persons or agents issuing title insurance policies, would prohibit the rebate of premiums, would require approval of forms by the Commissioner of Insurance, and would require the Commissioner of Insurance to adopt premium rates.

## Missouri

Senate Bill 385 imposes an annual Administrative surcharge on all workers' compensation policies with a deductible option that are written or renewed on or after January 1, 2004. In calculating the administrative surcharge owed pursuant to the provisions for workers' compensation policies with deductible options, the administrative surcharge owed will be based upon the total premiums, which would have been paid for the deductible portion. The annual administrative surcharge assessed shall be set at the same rate as the premium tax imposed.

Pursuant to a Division of Workers' Compensation Memorandum dated January 31, 2003, the workers' compensation administrative tax will be 2% and the Second Injury Fund surcharge will be 4%.

## Montana

Senate Bill 484 provides that an employer located in a legislatively created empowerment zone is allowed a credit against Montana insurance premium tax for qualifying new employees.

*In New Jersey, Republican Gov. Jim McGreevey on June 9 signed legislation into law that will be "the first fundamental change to the state's auto system in 30 years," said Insurance Commissioner Holly C. Bakke. "For 30 years, we have had a very difficult marketplace," she told National Underwriter. "The message that is so important is that for 30 years people have been running away from New Jersey. We want to get the message out that we're different and we're open for business."*

Caroline MacDonald, *Issues Vary For Regs In Four Large States*,
National Underwriter, June 17, 2003, no page.

## Nebraska

Legislative Bill 216 will require every insurance company holding a certificate of authority to transact the business of insurance in the state to file with the Director or, if required by the Director, with the National Association of Insurance Commissioners. Companies must file on or before March 1 of each year an annual financial statement for the year ending December 31 immediately preceding the current year on forms prescribed by the Director.

House Bill 130 eliminates the insurance premium tax exemption for payments by the state for Medicaid managed care.

## New Mexico

House Bill 420 increases the insurance premium tax rate from 3% to 3.003% of gross premiums and membership and policy fees received by insurers subject to the premium tax on insurance or contracts covering risks within the state during the preceding calendar year, less all return premiums, including dividends paid or credited to policyholders or contract holders and premiums received for reinsurance on New Mexico risks.

## New York

Assembly Bill 2106:

- The bill significantly changes the tax scheme for property and casualty insurers by eliminating the tax based on income and capital, and imposing only a variable rate tax on premiums. The rate of tax will be 1.75% for accident and health insurance and 2% for all other types of non-life insurance.

- The bill imposes a minimum tax on property and casualty insurers of $250.

- The bill imposes a minimum tax on life insurers equal to 1.5% of their New York net direct written premiums.

- The bill changes the allocation method for computing the MCTD surcharge for property and casualty companies. The surcharge will be based on a premium factor only.

- The bill excludes surplus and excess lines reinsurance premiums assumed from unauthorized companies from the premium tax base. This section of the bill is effective retroactively for tax years beginning on or after January 1, 1990. Refund claims based on this changed law for tax years that the statute of limitation already passed will be allowed if the refund claim is filed within 120 days of enactment.

- The bill provides that the credits established under section 1511, other than the retaliatory tax credit, shall not reduce the tax payable to less than the $250 minimum tax.

- The bill only allows life insurance companies the deduction of certain amounts paid to an attorney-in-fact for a mutual insurance company pursuant to subparagraph 15 of Tax Law section 208.9(a). This deduction was allowed to such an attorney-in-fact because the reciprocal insurer for which it acted reported entire net income to New York State that was increased due to the Federal election specified in subparagraph 15. Since the entire net income base of taxation for property and casualty insurance companies is eliminated by this bill, the deduction allowed to such an attorney-in-fact is no longer appropriate for such companies.

- The bill amends section 1085(e) of the Tax Law relating to penalties for underpayment of estimated tax to provide that corporations taxable under Article 33 of the Tax Law for taxable years beginning on or after January 1, 2003, that either have entire net income of $1 million or more in any of the three preceding taxable years, or taxable premiums of $3.75 million in any of such preceding taxable years cannot utilize the exceptions for addition to tax established in section 1085(d).

- The bill amends section 4223(c) of the Insurance Law to reduce the statutory minimum annuity nonforfeiture interest rate from 3% to 1½%. This provision shall take effect on July 1, 2003 and sunset on June 30, 2005.

> *New York in the next several weeks is expected to become the latest state to adopt a reciprocal licensing law for nonresident insurance producers, a state Assembly source said. The final language in the bill was the result of a three-way negotiation involving leadership of the Republican-controlled Senate, Democrat-controlled Assembly and Republican Gov. George Pataki, said Peter Newell, an aide to Assemblyman Alexander Pete Grannis, D-Manhattan, who chairs the Assembly Insurance Committee.*
>
> Daniel Hays, *N.Y. Producer License Bill Nears Final OK*, National Underwriter, Sept. 30, 2003.

## North Dakota

Senate Bill 2195 involves the North Dakota high-risk health insurance program referred to as CHAND. The first proposed change is a cost-savings measure which will extend the lifetime maximum benefit limit of $1,000,000 to include over-age-65 and disabled products. The second proposed cost-savings change excludes from CHAND those individuals that are eligible for medical benefits from other sources. The third proposal is the addition of a $2,500 deductible plan with an out-of-pocket maximum of $5,000. When CHAND's claims and expenses exceed its premium, the health insurance companies operating in North Dakota will be assessed to cover the deficiency, but are allowed a credit against their premium tax in the amount of the assessment.

## Ohio

House Bill 95 provides that where a domestic insurance company elects that a venture capital credit be nonrefundable, Ohio has established a ten-year carryforward of such credit.

## Oklahoma

House Bill 1017 allows the Oklahoma Health Care Authority to assess a quality assurance assessment fee upon each health maintenance organization that has a Medicaid managed care contract awarded by the state and administered by the Oklahoma Health Care Authority.

## Oregon

House Bill 3051 provides that each member insurer subject to an Oregon Insurance Guaranty Association assessment shall recoup the amount of the assessment through a recoupment assessment imposed on net direct written premiums.

House Bill 3183 changes the apportionment factor weighting from 80-10-10 premium-property-payroll to 90-5-5 premium-property-payroll, for taxable years beginning on or after July 1, 2006. The bill also increases the maximum R&D credit from $500,000 to $750,000.

House Bill 5059 establishes increased license fees and certificate of authority renewal fees.

## Pennsylvania

In In re: Principal Mutual Life Insurance Company, Philadelphia Tax Review Board Docket No. 36BPMERZZ9761 (February 26, 2003) the Philadelphia Tax Review Board ("Board") held that an Iowa based insurance company that owned and operated buildings in Philadelphia was subject to the Philadelphia Business Privilege Tax ("BPT") on its rental income and gross receipts from its real estate business. Principal Mutual Insurance Company owned and operated two buildings in Philadelphia for 5 years before selling them in 1998. The City of Philadelphia assessed BPT on the rental income and gross receipts realized by Petitioner for this real estate business during the years 1993 through 1998.

## South Carolina

Senate Bill 549 amends the insurance premium tax law, so as to change the basis on which these taxes are assessed from premiums collected to premiums written.

> *A last minute rush to include captive insurer legislation, including a cap on premium taxes of $100,000, proved fruitful for the domicile of South Carolina.*
>
> Caroline MacDonald, *S.C. Passes $100,000 Captive Premium Tax Cap*, National Underwriter, Jun. 12, 2003.

## South Dakota

House Bill 1180 repeals the sunset provisions concerning the reduced South Dakota insurance gross premium tax rates imposed on domestic and foreign insurance companies for premiums on life insurance policies and considerations on annuity contracts. The provisions were scheduled to expire on July 1, 2003. Therefore, life insurance policy premiums will continue to be taxed at 2.5% on the first $100,000 of annual premiums and 0.08% of those premiums exceeding $100,000, and annuity contract considerations will continue to be taxed at 1.25% of the first $500,000 of consideration and 0.08% of any contract considerations exceeding $500,000. Without the repeal of these sunset provisions, the rates would have reverted to a flat 2.5% rate on all life insurance premiums and a flat 1.25% rate on annuity contract considerations.

## Tennessee

House Bill 2056 and Senate Bill 1929 amend Tennessee Annotated, Title 56, relating to the filing of annual statements by county mutual fire insurance companies and the filing of premium tax for surplus lines insurance. Companies are not limited in the number of rate filings that can be made during a year. However, additional rate filings require a fee of $250 plus all costs incurred by the Commissioner for an actuarial review of the rate filing. Required annual statements of a company's financial condition, submitted to the Commissioner, must be accompanied by a $50 fee.

## Texas

Senate Bill 637 relates to elimination of payments by the state for national insurance database fees, and requires insurance companies to pay the cost of preparing and furnishing to the National Association of Insurance Commissioners the information required.

House Bill 2292 provides that, for purposes of computing the premium tax under Section 2.110 of the Insurance Code, a managed care organization shall be treated in the same manner as a health maintenance organization.

According to the Texas Comptroller, taxes on a properly placed surplus lines policy should be collected from the insurance company and remitted by the licensed surplus lines agent and therefore the insurer should not file any tax report forms for such business. Texas Comptroller of Public Accounts, Position Letter No. 200304822L (April 3, 2003). Also, any business the insurer may have in Texas that was not placed through a licensed surplus lines agent and which does not qualify as an independently procured placement may be an unauthorized insurance contract. The insurer is responsible for the payment of the unauthorized premium tax, regardless of whether the company is an eligible surplus lines insurer or has no standing at all in the state.

A Texas county mutual insurance company is exempt from Texas franchise tax based on Section 171.052 according to the Texas comptroller. Texas Comptroller of Public Accounts, Position Letter No. 200304826L (April 8, 2003). Because county mutual insurance companies are subject to the premium tax, they are exempt from the payment of franchise tax.

The Texas Comptroller of Public Accounts has held that an insurance company's purchases of motor vehicles were subject to Texas motor vehicle sales and use tax. Decision, Texas Comptroller of Public Accounts, Hearing No. 42,318, July 25, 2003. The taxpayer, a health insurance provider, unsuccessfully argued that insurance companies paying Texas insurance gross premium tax are not subject to any other taxes administered by the state, with the exception of specific taxes set forth in the Texas Insurance Code. The ALJ found that insurance companies are subject to motor vehicle sales tax because the tax is not related primarily to operating as an insurance carrier.

> *In Texas, a major homeowners reform bill was passed by the legislature and signed on June 10 by the Texas Governor, Republican Rick Perry. Texas Commissioner Jose Montemayor said in a statement that S.B. 14, passed this session, is "landmark legislation. For the first time in our history, every property and casualty insurer is subject to rate standards," he said.*
>
> Caroline MacDonald, *Issues Vary For Regs In Four Large States*,
> National Underwriter, June 17, 2003, no page.

The Texas premium tax on insurance companies is lowered if a company maintains a certain percentage of specific Texas investments. United American Insurance Company (United), a Colorado-based insurance company, owns an interest in limited partnerships to harvest Texas mineral resources. On premium tax returns, United listed these partnerships as Texas property entitling them to a lower tax liability. Before the Court of Appeals, United contended that Texas Ins. Code. Ann. Article 4.11, which grants the premium tax reduction, should be read in conjunction with article 3.33, which regulates insurance company investments. Because insurance companies are allowed to make partnership investments in mineral producing properties, United argued that the investments qualified as Texas property. The comptroller countered that "real property, or any interest therein" found in article 4.11 refers only to interests in land and because partnership interests are personal property and not real property, United's interests do not qualify. The court found in favor of the comptroller based on the fact that there is no indication that articles 4.11 and 3.33 were to be read together. The court also found that under Texas law, the limited partnerships held by United were personal property, not a qualifying Texas investment under article 4.11. *United American Ins. Co. v. Strayhorn*, (No. 03-02-00722-CV), May 22, 2003.

## Utah

House Bill 372 modifies the Utah insurance code to provide for the regulation and operation of captive insurance companies. The act regulates the scope of the business, requirements for incorporation, certificates of authority, financial responsibility, and annual reports. The act also provides for inspections and examinations and establishes grounds for suspension and revocation. The act establishes investment requirements and premium taxes, and provides procedures for certain conversions and mergers. The act takes effect July 1, 2003.

House Bill 373 modifies the Utah insurance law by increasing the annual fees assessed against insurers from a range of $75 - $11,500 to a range of $150 - $12,350.

## Vermont

House Bill 452 adjusts the premium tax rate on captive insurance companies in each calculation bracket by changing the rate from four-tenths of one percent of the first 20 million dollars, to 38 hundredths. It also changes the rate from three-tenths of one percent on the next 20 million dollars to 285 thousandths of one percent; the rate from two tenths of one percent on the next 20 million dollars to 19 hundredths of one percent, and; the rate from 75 to 72 thousandths of one percent on each dollar thereafter on direct premiums. The bill makes similar rate calculation adjustments to assumed reinsurance premiums.

## Virginia

Senate Bill 854 specifies that penalties owed for failure to pay license taxes timely are due within 14 days of the date of the notice to the delinquent insurer.

Senate Bill 1264 amends and reenacts Section 32.1-276.8 (Effective until July 1, 2008), with regards to fees for processing, verification, and dissemination of insurance data. Under the reenacted statute, health maintenance organizations are subject to a tiered fee structure based on their number of enrollees in order to cover the costs of supplying data. Under the statute, such fees cannot exceed $3,000 for each health maintenance organization required to provide information.

## Washington

House Bill 2040 adds an interest penalty to delinquent premium tax payments to the state by insurers.

*Washington, D.C., which enacted captive legislation in 2001, has set its sights on becoming one of the top domiciles worldwide, according to its new captive director. He said it is "entirely possible to have D.C. regarded as a top-notch domicile for captives, and that is not taking anything away from the other domiciles."*

Caroline McDonald, *D.C. Domicile Strives For Flexibility*, National Underwriter, Aug. 12, 2003. No page.

## West Virginia

Senate Bill 485 establishes procedures for offers in compromise entered into by the insurance commissioner, with taxpayers, over disputed insurance tax claims. The bill also requires the insurance commissioner to obtain approval from the attorney general for compromises involving tax amounts of $15,000 or more.

House Bill 2715 replaces the excess lines broker tax with a surplus lines insurance tax of 4% of the gross premiums and gross fees charged by licensed surplus lines insurers, less return premiums, for surplus lines insurance.

The West Virginia Department of Tax and Revenue issued section 110-13P-1 (Volume XX, Issue 14), to clarify and explain the application of the tax credit for medical malpractice insurance premiums. The credit is authorized for taxable years beginning after December 31, 2001. The credit is equal to ten percent of the adjusted annual medical liability insurance premium for the taxpayer's specialty or subspecialty group; or, ten percent of the taxpayer's actual annual medical liability insurance premium. Filed: April 1, 2003. Effective May 1, 2003.

## Wisconsin

Senate Bill 197 changes the premiums factor for apportionment purposes beginning after 2005 as follows: for taxable years beginning after 2005, 60% premiums and 40% payroll; for taxable years beginning after 2006, 80% premiums and 20% payroll; and for taxable years after 2007, 100% premiums.

# Information reporting

chapter 12

Income recipients, or payees, use information returns to calculate their total income, taxes withheld, and net tax due each year. Income and expenses reported on information returns are significantly more likely to be properly reported on individual income tax returns than items that are not reported to the IRS by third parties. The IRS uses those same information returns to ensure that taxable income reported by payees is both accurate in amount and properly classified. As a result of this connection between information returns and “voluntary compliance” Congress and the IRS continue to impose new and additional reporting requirements on information return filers. Also, since insurance companies make a variety of payments to employees, service providers, shareholders, bondholders, and others, an understanding of the federal information reporting requirements is necessary to ensure compliance with the tax laws.

## TIN matching program – Rev. Proc. 2003-9

The IRS has announced an online taxpayer identification number (TIN) matching program available to virtually all payors of reportable payments and their authorized agents.[138] Participation in the program by an insurance company should reduce the number of B Notices and Notice 972CG proposed penalties that the company receives.

TIN matching requests can currently be submitted via the internet through an interactive session during which a payor can confirm up to 25 name/TIN combinations. The IRS promises that in the near future a bulk transfer program will also be available through which a payor will be able to send the IRS up to 100,000 name/TIN combinations for confirmation within a 24 hour period. Note that the IRS can only confirm whether or not a name/TIN combination matches within its system (for example, the program will confirm whether or not Mary Jones' social security number is actually 123-45-6789), it cannot provide a taxpayer's correct TIN.

For enrollment information in the program, go to irs.gov, E-File Services.

## Non-resident alien withholding and reporting

Accounts payables departments making payments to service providers increasingly are exposed to liability for failure to properly identify, document, report, and, if necessary, withhold on payments to foreign vendors.

The withholding-at-source regime under Section 1441, effective January 1, 2001, introduced a complex series of mandatory rules applicable to payments made to non-resident alien ("NRA") individuals, foreign corporations, and foreign partnerships. Payments of U.S. source income to any of these foreign recipients are subject to 30-percent withholding at source, unless exempted. Further, CFCs of U.S. companies are subject to Section 1441 withholding and reporting. In the absence of required documenta-

[138] Rev. Proc. 2003-9, 2003-8 I.R.B. 1.

tion, complex mandatory presumption rules apply to determine the type of payee and character of income paid.

Experience suggests that the majority of invoices received from foreign vendors are silent as to whether any portion of the services rendered by the vendor were rendered in the United States, thus giving rise to U.S. source income. In light of the section 1441 rules, all foreign vendors should be required to provide on each invoice to a U.S. company and its CFCs a clear statement as to whether any of the foreign vendor's services were rendered in the U.S. (e.g., where employees of the foreign vendor have traveled to the U.S. for meetings or other work performed for the U.S. payor).

## Individuals

NRA independent contractors generally may benefit from treaty rate reductions (if available) if properly claimed on Forms 8233. The form requires a taxpayer identification number, should be collected 10 days prior to the payment, and must be filed with the IRS by the payor within 5 days of its receipt.

## Foreign corporations

Foreign corporations may claim reduced withholding based either upon a claim that the income is effectively connected with their conduct of a U.S. trade or business, if applicable (i.e., on a properly completed Form W-8ECI), or alternatively on a claim of treaty rate reduction benefits (Part II, Form W-8BEN). An employer identification number for the vendor is required on either form.

### Foreign partnerships

Alternative procedures apply in the case of foreign partnerships in their capacity as flow-through entities. Generally, foreign partnerships must claim their status as intermediaries by providing accounts payables departments with Form W-8IMY, underlying Forms W-8BEN or W-9s (if applicable) for each partner, and a written allocation statement. The payables department then must treat each payment as though made directly to the underlying partner. In most instances, this regime is impractical; more practical alternative procedures will cause the accounts payables department to withhold at source on the full payment irrespective of any treaty rate reduction benefits otherwise inuring to the partners, or the furnishing of a Form W-8ECI by the partnership to the payor.

## Reasonable cause procedures

The IRS has begun to use an automated tool known as the “Reasonable Cause Assistant” (RCA) to assist its employees in making reasonable cause penalty determinations. In addition, the consideration of taxpayer requests for penalty abatements on the ground of reasonable cause will be centralized at the IRS Cincinnati Service Center. This centralization and the deployment of the RCA are intended to result in more consistent treatment of penalty cases and to provide taxpayers with clearer and more detailed explanations if their abatement requests are denied. IRS use of the RCA will not limit or otherwise affect the taxpayer’s appeal rights regarding a penalty abatement request that is denied.

The Cincinnati Service Center has recently begun to challenge and deny requests for abatement of information return penalties when the filer has either not clearly demonstrated that they have satisfied the reasonable cause requirements of Treas. Reg. section 301.6724-1, or have never reported backup withholding on a Form 945, Annual Return of Withheld Federal Income Tax. Under Treas. Reg. section 301.6724-1, a filer must show that there are significant mitigating factors with respect to the failure giving rise to the penalty, or that the failure arose from events beyond the filer's control. In addition, the filer must show that they acted in a responsible manner both before and after the failure occurred.

According to the regulation, significant mitigating factors include the fact that the filer has an established history of complying with the information reporting requirements. Furthermore, one of the events that the regulation specifically states establishes an event beyond the filer's control is "certain actions of the payee… providing necessary information with respect to the return." Therefore, an insurance company that has complied with its information reporting requirements in the past, and whose penalties are caused by a payee's failure to provide any information, as in the case of a missing TIN, or failure to provide correct information, as in the case of an incorrect TIN, can and should state in their response to a Notice 972-CG that they can establish BOTH a significant mitigating factor AND a failure that arose as a result of events beyond the filer's control.

A filer must also show that they have acted in a responsible manner both before and after the filing of the incorrect information returns. With respect to missing and incorrect TINs, the regulation provides specific requirements that the filer must satisfy. For a missing TIN, a filer must show that they solicited the TIN from the payee before an initial payment was made to the payee. They must also undertake a first annual solicitation before the end of the calendar year in which that payment was made, and a second annual solicitation before the end of the following calendar year.

*Even after the process of centralizing penalty cases at the Cincinnati Service Center has been completed, taxpayers should continue (absent any future specific guidance to the contrary) to submit requests for abatement to the IRS office or Service Center that issued the penalty notice.*

For an incorrect TIN, a filer must show that they solicited the TIN from the payee before an initial payment was made to the payee. They must also undertake a first and second annual solicitation after receiving notice that the payee's TIN is incorrect. However, if the filer received a B Notice with respect to the same incorrect name/TIN combination, then their annual solicitation requirement will have been satisfied.

## Backup withholding rates

The Jobs and Growth Tax Relief Reconciliation Act of 2003 resulted in a retroactive decrease in the backup withholding rate imposed by section 3406 from 30% to 28% effective with respect to payments made after December 31, 2002. However, payors were not obligated to refund excess withholdings. Instead, affected payees can claim refunds of over-withheld tax on their 2003 income tax returns. Furthermore, payors were given until July 1, 2003 to change the rate at which they withheld to 28%.

*Note that the new backup withholding rate has yet to be reflected in many IRS products, including Instructions for the Requester of Forms W-9 and W-8, several technical publications, and Forms W-9, 1099, and W-2G.*

## Procurement card reporting – Rev. Proc. 2003-44

During 2003, the IRS issued proposed regulations and revenue procedures[139] which clarify that a company that uses "procurement" or "payment" cards to pay for reportable transactions must report such payments on Forms 1099 as though they had been paid by check or any other method of payment.

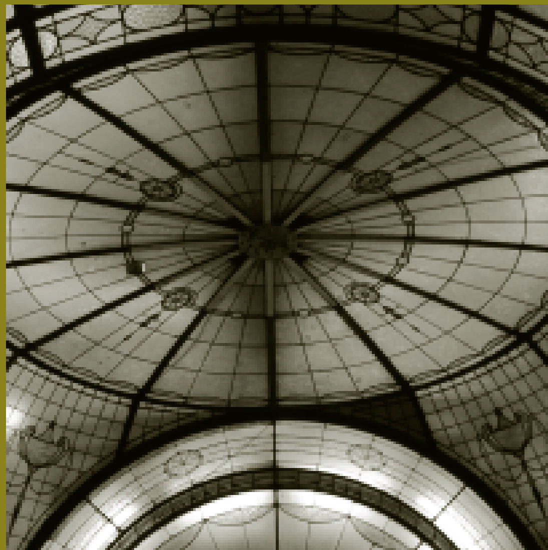
[139] Rev. Proc. 2003-44, 2003-25 I.R.B. 1051

**OBTAINING OFFICIAL IRS REPORTING INFORMATION**

*The IRS operates a centralized call site to answer questions about information reporting. From 8:30 am to 4:30 pm (Eastern Standard Time), payors may call the IRS IRP call site at 304.263.8700.*

The proposed rules would allow payment card organizations to act on behalf of cardholder/payors for purposes of soliciting, collecting, and validating merchant/payees' names and TINs, provided certain requirements are met. Furthermore, payors would be permitted to rely on coding information supplied by their payment card companies indicating whether payments made via their cards constitute either reportable or exempt purchases.

# Tabulation of court cases, rulings, and regulations



# appendix A

# Cases/petitions

***American Elec. Power. Co., Inc. v. U.S. 326 F.3d 737 C.A.6 (Ohio),2003.*** April 28, 2003. The Sixth Circuit Court of Appeals affirmed the District Court decision that American Electric Power's corporate owned life insurance program was an economic sham.

***Blue Cross and Blue Shield of Texas, Inc. and Subsidiaries v. Commissioner of Internal Revenue No. 02-60188 (16 Apr 2003).*** The 5th Circuit Court of Appeals affirmed the Tax Court ruling that coordination of benefit savings between health insurance companies would not qualify as a special deduction for estimated salvage recoverable under the Omnibus Budget Reconciliation Act of 1990.

***Blue Cross & Blue Shield United of Wisconsin v. U.S. 56 Fed.Cl. 697. June 12, 2003.*** The Federal Court of Claims ruled that Blue Cross Blue Shield of Wisconsin (BCW) must use the actuarial estimate of unpaid loss reserves as of December 31, 1986, as reported on its annual statement to calculate the section 832(c)(4) deduction for tax year 1987.

***Dow Chemical Co. and Subsidiaries v. U.S. 250 F.Supp.2d 748 E.D.Mich., 2003. March 31, 2003.*** The IRS improperly disallowed Dow Chemical's deductions for interest claimed on Dow's tax returns in connection with its corporate owned life insurance plans and ordered the IRS to refund $22,209,570, plus interest.

***John Hancock Financial Services, Inc. v. U.S. 92 A.F.T.R.2d 2003-5304, July 15, 2003.*** The Federal Court of Claims ruled that John Hancock Insurance Company may not use recomputed differential earnings amounts not allowable as deductions to exclude future income.

***Travelers Insurance Company v. United States. No. 02-1745, Oct. 6, 2003.*** The Supreme Court denied Certiorari to Travelers Insurance Company in its suit with the IRS involving the policyholders' share of investment income excluded in calculating Travelers Insurance Co.'s foreign tax credit.

## IRS rulings/notices/procedures/FSAs

**Rev. Rul. 2003-17, 2003-6 I.R.B.1** The IRS addressed the issue of whether a foreign life insurance company carrying on an insurance business in the U.S. determines the amount of income effectively connected with its U.S. business based exclusively on the amount of income reported on the NAIC annual statement.

**Rev. Rul. 2003-19, 2003-7 I.R.B.1** The IRS described the tax consequences resulting from three fact patterns involving a mutual company conversion.

**Rev. Rul. 2003-24, 2003-10 I.R.B.1** The IRS released prevailing state assumed and applicable federal interest rates for tax years beginning after December 31, 2001.

**Rev. Rul. 2003-34, 2003-17 I.R.B. 813** The IRS ruled that if an insurance company takes a deduction under section 847 in a taxable year, the company is not required to request the permission of the Secretary or his delegate in order to discontinue using section 847 in a subsequent year.

**Rev. Rul. 2003-76, 2003-33, I.R.B. 355** The transfer of a portion of Contract B to Company C for new Contract C is a tax-free exchange under section 1035. The continued existence of Contract B with its reduced cash value does not affect the tax-free exchange.

**Rev. Rul. 2003-91, 2003-33 I.R.B. 347** The IRS ruled that the holder of a variable contract will not be considered to be the owner, for federal income tax purposes, of the assets that fund the variable contract.

**Rev. Rul. 2003-92, 2003-33 I.R.B. 347** The IRS ruled that the holder of a variable annuity or life insurance contract will be considered to be the owner of the partnership interests that fund the variable contract if interests in the partnerships are available for purchase by the general public.

**Rev. Rul. 2003-95, 2003-33 I.R.B. 358** The Rev. Rul. discusses three situations where the policyholder surrenders a percentage of a life insurance contract and receives a cash distribution and where the death benefit decreases as a result.

**Rev. Rul. 2003-120, 2003-48, I.R.B. 1154** The IRS clarified the amount of reserves used to calculate "required interest" under section 812(b)(2)(A).

**Rev. Proc. 2003-1, 2003-1 I.R.B. 1** The IRS released revised procedures for IRS issuances.

**Rev. Proc. 2003-2, 2003-1 I.R.B. 1** The IRS released revised procedures for IRS issuances.

**Rev. Proc. 2003-3, 2003-1 I.R.B. 1** The IRS released areas in which advance rulings will not be issued.

**Rev. Proc. 2003-4, 2003-1 I.R.B. 1** The IRS released revised procedures for furnishing ruling letters, information letters, and technical advice.

**Rev. Proc. 2003-5, 2003-1 I.R.B. 1** The IRS released revised procedures for furnishing ruling letters, information letters, and technical advice.

**Rev. Proc. 2003-5, 2003-1 I.R.B. 1** The IRS released revised procedures for furnishing ruling letters, information letters, and technical advice.

**Rev. Proc. 2003-7, 2003-1 I.R.B. 1** The IRS released areas in which advance rulings will not be issued.

**Rev. Proc. 2003-9, 2003-8 I.R.B. 1** The IRS expanded the Taxpayer Identification Number program to allow all payors to participate in TIN matching for reportable payments.

**Rev. Proc. 2003-11, 2003-4 I.R.B. 3** The IRS announced the launch of an initiative aimed at bringing taxpayers who used "offshore" payment cards or other offshore financial arrangements to hide their income back into compliance with tax law.

**Rev. Proc. 2003-17, 2003-6 I.R.B. 1** The IRS issued loss payment patterns and discount factors for the 2002 accident year.

**Rev. Proc. 2003-18, 2003-6 I.R.B. 1** The IRS issued salvage discount factors for the 2002 accident year.

**Rev. Proc. 2003-24, 2003-11 I.R.B. 599** The IRS excluded certain loss transactions from the tax shelter disclosure requirement.

**Rev. Proc. 2003-25, 2003-11 I.R.B. 1** The IRS provided that certain book-tax differences are not taken into account in determining whether a transaction is reportable under Treas. Reg. section 1.6011-4(b)(6).

**Rev. Proc. 2003-41, 2003-25 I.R.B. 1044** The IRS made the Fast Track Settlement program for large and mid-size businesses (LMSB) permanent. The Rev. Proc. contains guidance designed to help taxpayers and the IRS reach agreement on tax disputes more quickly

**Rev. Proc. 2003-44, 2003-25 I.R.B. 1051** The IRS issued proposed regulations and revenue procedures which clarify that a company that uses "procurement" or "payment" cards to pay for reportable transactions must report such payments on Forms 1099 as though they had been paid by check or any other method of payment.

**Rev. Proc. 2003-47, 2003-28 I.R.B. 55** The IRS provided new procedural rules for the 953(d) election which allows certain foreign insurance companies to elect to be treated as domestic corporations for U.S. tax purposes.

**Rev. Proc. 2003-70, 2003-34 I.R.B. 406** The IRS set forth the domestic asset/liability percentages and domestic investment yields needed by foreign life insurance companies and foreign property and liability insurance companies to compute their minimum effectively connected net investment income.

**Rev. Proc. 2003-78, 2003-45 I.R.B. 1029** Provides instructions for establishing exemption from the section 4371 excise tax on insurance premiums paid to a foreign insurer or reinsurer when the exemption is based on the provisions of an income tax treaty to which the United States is a party.

**Rev. Proc. 2004-9, 2004-2 I.R.B. 1** Prescribes the loss payment patterns and discount factors for the 2003 accident year.

**Rev. Proc. 2004-10, 2004-2 I.R.B. 1** Prescribes the salvage discount factors for the 2003 accident year.

**Notice 2003-26, 2003-18 I.R.B. 1** The IRS requested suggestions for regulations, rulings, and other administrative guidance that should be included on the 2003-2004 Guidance Priority List.

**Notice 2003-31, 2003-21 I.R.B. 948** The IRS announced that the Treasury Department and the IRS intend to propose regulations providing guidance under section 501(m), which will define the term “commercial-type insurance” and address how section 501(m) applies to organizations described in section 501(c)(3) and section 501(c)(4), including health maintenance organizations.

**Notice 2003-34, 2003-23 I.R.B. 990** The IRS addressed certain offshore insurance companies which invest in hedge funds and use the arrangements to defer recognition of ordinary income or to characterize ordinary income as a capital gain.

**Notice 2003-35, 2003-23 I.R.B. 992** The IRS reminded taxpayers that an entity must be an insurance company for federal income tax purposes in order to qualify as an exempt organization described in section 501(c)(15) of the Internal Revenue Code.

**Notice 2003-51, 2003-33 I.R.B. 361** Treasury is considering whether to promulgate regulations that would prescribe the tax treatment of tax-free exchanges of annuity contracts under sections 72(e) and 1035.

**Notice 2003-69, 2003-42 I.R.B. 851** Lists the U.S. income tax treaties that are acceptable for determining whether dividends paid by foreign companies resident in a treaty country can qualify for the new maximum 15-percent rate of tax on qualified dividends received by U.S. non-corporate taxpayers.

**Notice 2003-71, 2003-43 I.R.B. 922** Defines “readily tradable on an established U.S. securities market” for purposes of determining whether dividends paid by foreign companies can qualify for the new maximum 15 percent rate of tax on qualified dividends received by U.S. non-corporate taxpayers.

**Chief Counsel Notice 2003-12 (9 Apr 2003)** The IRS outlined procedures for requesting tax accrual and other tax-related financial audit workpapers.

**Announcement 2004-4 (30 Dec 2003)** The IRS proposed new Form 8858 requiring information reporting by U.S. persons that own foreign entities that are disregarded for U.S. tax purposes.

## Private letter rulings and technical advice

**PLR 200302022 (10 Jan 2003)** A consolidated group and its life-nonlife election will remain in existence after it restructures its holdings.

**PLR 200303028 (17 Jan 2003)** The liquidation of two life insurance subsidiaries into their parent will not modify the subsidiaries' life insurance or annuity contracts.

**PLR 200307080 (14 Feb 2003)** The liquidation of a mutual holding company following the sale of its subsidiaries produces capital gain for members who held policies through the insurance subsidiary.

**PLR 200308032 (21 Feb 2003)** Ownership of interests in institutional mutual funds by section 457(b) deferred compensation plans will not prevent satisfaction of the look-through rule.

**PLR 200313016 (28 Mar 2003)** A life insurer's proposed distribution methods on the death of an annuity owner will satisfy the requirements of section 72.

**PLR 200317019 (25 Apr 2003)** The conversion of a nonprofit nonstock public benefit corporation to a for-profit stock corporation qualifies as a tax-free recapitalization under section 368(a)(1)(E).

**PLR 200320020 (16 May 2003)** The IRS granted a waiver under section 7702(f)(8) for the failure of life insurance policies.

**PLR 200321013 (23 May 2003)** An Irish reinsurance company is eligible for exemption from section 4371 excise taxes under the terms of the U.S.-Ireland income tax treaty.

**PLR 200323016 (6 Jun 2003)** An Irish reinsurance company is eligible for exemption from section 4371 excise taxes under the terms of the U.S.-Ireland income tax treaty.

**PLR 200327037 (6 Jun 2003)** The IRS waived the failure of life insurance policies under section 7702(f)(8).

**PLR 200327047 (3 July 2003)** Insurance policy premiums paid to a German reinsurance company on U.S. risks are exempt from section 4371 insurance excise taxes under the U.S.-Germany income tax treaty.

**PLR 200327052 (3 July 2003)** Financial reserve calculations of two foreign insurance companies, prepared for local regulatory purposes, are an appropriate means of measuring income for purposes of subpart F.

**PLR 200327063 (3 July 2003)** One of two substantially identical rulings regarding the tax consequences of two Companies' proposed transfers of assets held in retired health reserves to voluntary employees' beneficiary associations (VEBAs).

**PLR 200327066 (3 July 2003)** The second of two substantially identical rulings regarding the tax consequences of two Companies' proposed transfers of assets held in retired health reserves to voluntary employees' beneficiary associations (VEBAs).

**PLR 200328027 (11 July 2003)** The IRS granted a waiver under section 7702(f)(8) for the failure of life insurance policies.

**PLR 200332014 (8 Aug 2003)** The IRS granted revocation of Taxpayer's section 831(b) election.

**PLR 200333024 (15 Aug 2003)** A mutual P&C company's conversion to a stock corporation is a tax-free reorganization.

**PLR 200340011 (July 1, 2003)** Extended service contracts to be issued by Taxpayer are insurance contracts for federal income tax purposes and Taxpayer qualifies as an "insurance company" for purposes of section 831 of the Code.

**PLR 200341019 (July 8, 2003)** Certain reserves held by a foreign subsidiary required to be set forth on the financial statements and filed with the life insurance regulator of its country of domicile are an appropriate means of measuring income within the meaning of section 954(i)(4)(B)(ii).

**PLR 200342003 (July 9, 2003)** The exchange of a portion of a variable annuity contract for a deferred annuity contract qualifies for tax-free exchange treatment under section 1035.

**TAM 200322017 (30 May 2003)** Insurance settlement payments received by Taxpayer under third-party Commercial General Liability ("CGL") policies are received for indemnification with respect to tort liability, not an involuntary conversion under section 1033(a)(2).

**TAM 200323002 (6 Jun 2003)** Taxpayer's calculation of the limitation on the charitable contributions deduction was inappropriate and that a life-nonlife consolidated group must determine its consolidated taxable income on a subgroup basis in accordance with Treas. Reg. section 1.1502-47(a)(2).

**TAM 200323026 (6 Jun 2003)** Amounts paid by a parent and its subsidiaries to a related captive insurance company for pollution liability coverage are not deductible insurance premiums under section 162.

**TAM 200325001 (20 Jun 2003)** Taxpayer's Funding Agreements do not constitute insurance or annuity contracts for tax purposes. Accordingly, the accumulated funds held by Taxpayer did not constitute a reserve item under section 807(c).

**TAM 200328006 (11 July 2003)** Actuarial Guideline 33 (AG33) may not be used in computing Taxpayer's Commissioners' Annuities Reserve Valuation Method (CARVM) tax reserves for annuity contracts that were issued before the date on which the guideline took effect.

**TAM 200330002 (25 July 2003)** Short-term capital gains included within dividends paid by a regulated investment company are not taken into account under the basis adjustment rules of section 817(b).

**TAM 200334005 (22 Aug 2003)** Expenses incurred by Taxpayer to diversify its life insurance and annuity products, and expand its distribution channels, are ordinary and necessary business expenses, not capital expenditures under section 263(a).

## Regulations

**Section 61, 83, 301, 1402, and 7872 Regulations (68 FR 24898-01, May 9, 2003 )** The IRS issued proposed regulations on the valuation of economic benefits (including an interest in policy cash value) under certain equity split-dollar life insurance arrangements, in particular the rules for valuing economic benefits provided to the non-owner under an equity split-dollar life insurance arrangement governed by the economic benefit regime.

**Section 61, 83, 301, 1402, and 7872 Regulations (TD 9092)** The IRS issued final split-dollar regulations. The final regulations are substantially similar to the temporary regulations published in July 2002. The regulations apply to all new arrangements entered into on or after September 17, 2003 and to existing arrangements that are materially modified on or after that date.

**Section 706 Regulations (68 Fed. Reg. 146893-115037, Sept. 10, 2003)** The IRS issued proposed regulations on transfer pricing for services, including services related to intangible property.

**Section 6011 Regulations (68 Fed. Reg. 10161-10178, Mar. 3, 2003)** The final regulations relate to the filing of disclosure statements under section 6011(a), the registration of corporate tax shelters under section 6111(d), and the list maintenance requirements under section 6112.

**Revised Section 6011 Regulations (TD 9108)** Provide that the disclosure of confidential transactions on a return is limited to transactions for which an advisor has imposed confidentiality on a taxpayer to protect the advisor's tax strategies from disclosure, and the taxpayer directly or indirectly pays the advisor a minimum fee.

**Section 6662 and 6664 Regulations (TD 9109)** Final regulations under Sections 6662 and 6664 affect the defenses available to the imposition of the accuracy-related penalty for failure to disclose reportable transactions or positions taken contrary to Treasury regulations.

**Section 817A Regulations (68 Fed. Reg. 24349-24351, May 7, 2003)**
The IRS released final regulations defining the appropriate interest rate to be used in the determination of tax reserves and required interest for certain modified guaranteed contracts. The final regulations also address how temporary guarantee periods that extend past the end of a taxable year are to be taken into account. The final regulations replace proposed regulations released June 3, 2002.

**Section 817(h) Regulations (68 Fed. Reg. 163974-02, July 30, 2003)**
The proposed regulations under section 817(h) propose removing provisions of the Income Tax Regulations that apply a look-through rule to assets of a nonregistered partnership for purposes of satisfying the diversification requirements of section 817(h).

**Circular 230 Regulations (Fed. Reg. 122379-02, Dec. 19, 2003)**
Proposed changes to Circular 230 provide best practices for tax advisors and modify standards for certain tax shelter opinions.

## Treaties

Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains. Signed July 24, 2001.

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# appendix B

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