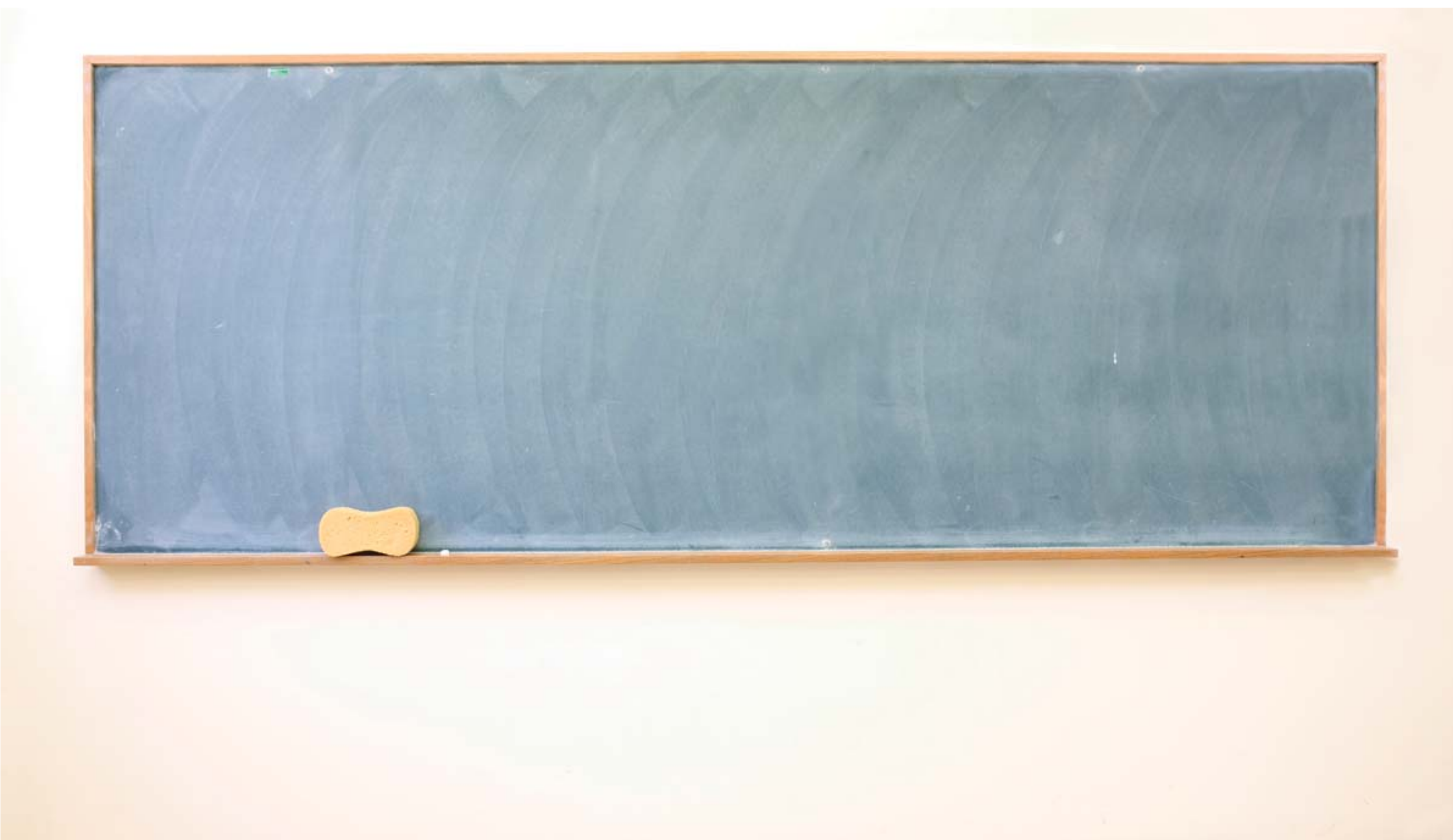
Continuing developments in the taxation of insurance companies*
2008—The year in review



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Forward

This monograph provides an overview of developments affecting the taxation of insurance companies in 2008. 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.

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Stormy weather – An economic "Katrina"

Despite a relatively active hurricane season, floods that ravaged the Midwest, and the California wild fires that have become an annual occurrence, it was the unpredicted and unprecedented economic storm that devastated the country in 2008. Congress, for its part, passed three pieces of legislation to address the situation. As the year progressed, the titles of the bills reflected more and more the realization of how bad the situation was—first was a "stimulus" bill, then a "recovery" bill, and finally a "stabilization" bill. No bill had any immediate impact. The economy dominated the 2008 Presidential election and will undoubtedly dominate the political landscape for the foreseeable future.

Liability in Times of Crisis

The massive financial losses are hitting the insurance industry in another way. Director and officer liability policies and error and omissions policies losses are on the rise in both frequency and severity.[1]

Economic rumblings

The year began with the continued collapse of the subprime market. Foreclosures skyrocketed in April[2] and continued to climb throughout the year. The pressure on homeowners spread to other parts of the economy, ultimately cracking confidence in the system.

In early March, rumors, short trading, and market conditions came to a head with the collapse of Bear Stearns, which had been floundering in the marketplace amid rumors of a cash crunch. The Federal Reserve (Fed) voted to use its extraordinary authority to lend to a nonbank for the first time since the Great Depression. The looming failure of an investment bank did not sit well with the markets. With unprecedented participation by the Treasury and the Fed, JP Morgan Chase acquired the company in mid-March.[3]

News of bank failures littered the headlines and by the end of 2008 more than 25 banks had failed.[4] The September failure of Washington Mutual was the largest failure ever of a US bank, as measured by assets, with a whopping $310 billion in assets. The previous record was set almost 25 years earlier by Continental Illinois National Bank in 1984 at a comparatively miniscule $40 billion.[5] By early September, the tide had risen high enough to flood even the most seemingly unsinkable companies. Not only were traditional banks in trouble, but mortgage giants, investment banks, and insurance companies were swept into the whirlpool.

1 John F. McCarrick, *Subprime Claims: D&O and E&O Liability and Coverage Implications (revised version)*, ADVISEN FPN, March 10, 2008.
2 Stephanie Armour, *Foreclosures Skyrocket 65% In April: Housing Downturn Might Last Into 2010, Some Experts Say*, USA TODAY, May 15, 2008.
3 Robin Sidel, Greg Ip, Michael Phillips, and Kate Kelly, *The Week that Shook Wall Street: Inside the Demise of Bear Stearns*, THE WALL STREET JOURNAL, March 18, 2008.
4 FDIC, Failed Bank List, http://www.fdic.gov/bank/individual/failed/banklist.html, December 29, 2008.
5 AP Online, *JP Morgan Chase buys WaMu Assets after FDIC Seizure*, Advisen FPN, September 25, 2008.

Merrill Lynch, Lehman Brothers, Morgan Stanley, and Goldman Sachs all felt the severe pinch of the credit crisis. The firms each had similar challenges, yet had starkly different results. Merrill Lynch was able to stay in the game long enough to find a suitor and benefit from the federal bail out. They sold their valuable stake in the Bloomberg reporting service and offloaded $31 billion of toxic assets at pennies on the dollar. By mid-September an agreement with Bank of America to purchase the entire company was reached, while Lehman Brothers was forced to file bankruptcy.[6]

Little help for Lehman

The Fed couldn't help Lehman because "there was no mechanism, there was no option, there was no set of rules, and there was no funding to allow us to address that situation. The Federal Reserve's ability to lend, which was used in the Bear Stearns case, for example, requires that adequate collateral be posted… In this case, that was impossible—there simply wasn't enough collateral to support the lending."—Ben Bernanke, Chairman of the Federal Reserve, on the Lehman Brothers failure[7]

Goldman Sachs and Morgan Stanley both converted to bank holding companies in order to gain customer deposits as a stable source of funding.[8] Where traditional banks rely on customer deposits for funding, investment banks rely heavily on borrowed money. As the credit crisis deepened, it became exceedingly difficult to secure credit, and with failure staring them in the face, both companies acted preemptively to secure their future. Goldman Sachs was further bolstered by a show of confidence from Warren Buffet and his investment of $5 billion into the battered company.[9]

AIG, a financial powerhouse, was not immune to the spiraling financial crisis. The company had significant losses on credit default swaps.[10] The company initially received an $85 billion loan from the government[11] that was expanded to include an additional $20.9 billion commercial paper program and a $38 billion credit facility.[12] Over time, the arrangements with the government have continued to shift, with the company later participating in the Troubled Asset Relief Program (TARP) and renegotiating some of the loans.[13]

On November 23, the government announced it would assist Citigroup and invest $20 billion in the company, in addition to $25 billion the company had received as part of TARP. The agreement also guaranteed against the "possibility of unusually large losses" on up to $306 billion of mortgage-backed loans and securities.[14] In return, the government received $7 billion in preferred shares of Citigroup and an agreement that Citigroup would help distressed homeowners.

6 *Id.*
7 John Cassidy, *Anatomy of a Meltdown: Ben Bernanke and the Financial Crisis*, THE NEW YORKER, December 1, 2008.
8 Kathy Chu and John Waggoner, *FAQs on Morgan-Goldman Changes: How Will Their Conversion Affect Us?*, USA TODAY, September 23, 2008.
9 Adam Shell, *Buffet Dives Into Pool Of Anxiety: Show of Confidence Could Payoff, Too*, USA TODAY, September 25, 2008.
10 Gretchen Morgenson, *Behind Biggest Insurer's Crisis, A Blind Eye to a Web of Risk*, THE NEW YORK TIMES, September 28, 2008.
11 *AIG Competitors May Gain Market Share as Behemoth Looks to Sell Assets*, ADVISEN FPN, September 23, 2008.
12 Mary Williams Walsh, *Fed Adds $21 Billion to Loans for AIG*, THE NEW YORK TIMES, October 31, 2008.
13 Alyn Ackerman, *AIG's New Deal Draws Mixed Reviews*, BEST'S INSURANCE NEWS, November 17, 2008.
14 Jeannine Aversa, *Government Unveils Bold Plan to Rescue Citigroup,* THE ASSOCIATED PRESS, November 24, 2008.

The declining state of Fannie Mae and Freddie Mac, which together own or back approximately $5.3 trillion in mortgages, or about half of all US mortgages,[15] further upset the markets. In July, the Treasury Department asked Congress to provide the federal authority to take an ownership stake in the companies and to get the Fed a role in setting capital requirements and other standards.[16] Treasury acted because of a growing belief that the two companies would not be able to survive, and that any failure would have a significant impact on the economy.[17] As a result, the government developed a plan to inject up to $200 billion into the two companies in exchange for $1 billion in preferred stock from each company and warrants to purchase almost 80 percent of each company's common stock.[18] The companies were placed into conservatorship. Treasury Secretary Hank Paulson has proposed that the entities no longer operate in their current form, but perhaps in a manner similar to public utilities going forward.[19]

The financial services industry was not the only casualty, just the first. The US auto industry, already suffering from lagging sales, was hit hard. Record numbers of car dealerships closed in 2008. After requesting help from Congress, TARP funds were made available to supply a $17.4 billion loan to General Motors and Chrysler.[20] Ford stated it had sufficient cash on hand to weather the crisis for the near term. By early 2009, several auto companies filed for bankruptcy.

What's $50 billion between friends?

In addition to the turbulent markets, subprime fiasco, and credit crunch, an old-fashioned scandal also erupted. Bernard Madoff, Chairman and Chief Executive Officer of Bernard L. Madoff Investment Securities, LLC[21], is accused of perpetrating the largest Ponzi scheme ever. The various feeder funds, which funneled money into Mr. Madoff's care, and their auditors, are now under scrutiny from investors who were bilked out of billions of dollars.[22]

The problem was not contained to the US markets. Russia saw its credit markets dry up and stock prices fall up to 60 percent due in large part to the fall in oil prices.[23] China has seen turmoil in its insurance markets as claims are being filed on investment-linked insurance accounts, which have fallen about 15 percent, prompting the claims. The large volume of claims and lack of withdrawal mechanisms in the insurance market may cause further declines.[24] European insurers have attempted to pick up market share lost by American insurance companies as a result of the economic meltdown.[25] Belgium, the Netherlands, and Luxembourg invested $16.4 billion in Fortis, Belgium's largest financial services firm, to help restore confidence in their markets.[26] And the China Insurance Regulator Commission has begun monitoring the management and supervision of insurance products with investment links.[27]

15 Nick Timiraos, *Fannie Freddie Salve Lauded*, THE WALL STREET JOURNAL, September 8, 2008.
16 Sue Kirchhoff and John Waggoner, *U.S. Moves to Support Fannie, Freddie,* USA TODAY, July 14, 2008.
17 Deborah Solomon, Sundeep Reddy, and Susanne Craig, *Mounting Woes Left Officials With Little Room to Maneuver*, THE WALL STREET JOURNAL, September 8, 2008.
18 Maya Jackson Randall, U.S. *Reaffirms Backing of Fannie, Freddie Stock*, THE WALL STREET JOURNAL, September 12, 2008.
19 Martin Crutsinger, Paulson: *Allowing Fannie Mae, Freddie Mac to Return to Old Operating Ways Is Not an Option*, THE ASSOCIATED PRESS, January 7, 2009.
20 John D. McKinnon and John D. Stoll, *U.S. Throws A Lifeline To Detroit*, THE WALL STREET JOURNAL, December 20, 2008.
21 *Down Jones Companies & Executives: Bernard L. Madoff,* DowJones Factiva, http://fce.factiva.com/pes/default.aspx?inrf=true&isai=true, January 7, 2009.
22 Michael J. de la Merced, *In Madoff's Wake, Scrutiny of Accounting Firms*, THE NEW YORK TIMES, December 22, 2008.
23 Tai Adelaja and Jeffrey Stinson, *Russia Among Hardest-Hit in Economic Meltdown*, USA TODAY, October 10, 2008.
24 Sino Cast, *China Investment-Linked Insurance Withdrawal Rate Up*, CHINA FINANCIAL WATCH, October 24, 2008.
25 Goran Mijuk, *DJ Focus: European insurers Think Expansion Amid Mkt Turmoil*, DOW JONES NEWSWIRES, September 22, 2008.
26 Matt Krantz, *Investors Hope Deal Spells Relief*, USA TODAY, September 29, 2008.
27 Sino Cast, *China Investment-Linked Insurance Withdrawal Rate Up*, CHINA FINANCIAL WATCH, October 24, 2008.

By the end of the year, pressures on insurance companies' balance sheets had become severe due to unrealized market losses and impairment resulting from fair value accounting. Fitch has lowered its rating outlook to "Negative" for many insurance and reinsurance sectors globally. The rating dip reflects the significant global credit and equity market slides and the volatility in the markets.[28]

Product pitfalls

Credit default swaps are taking much of the blame for the crisis. A credit default swap is a derivative designed to transfer credit exposure risk between parties. These instruments became wildly popular over the last several years, and the global market was approximately $55 trillion as of June 30, 2008.[29] These instruments were lightly regulated prior to 2008; however, governments at the federal and state level are examining these contracts to determine if they are insurance contracts.

Credit default swaps were especially precarious to the writers of the instruments. The writer was exposed to risk from three fronts: (1) payment if the underlying security defaulted, (2) if the counter party demanded payment because the insured security declined in value or had a drop in its rating, and (3) if the writer itself had its debt rating cut.[30] These simultaneous risks could create demand for significant simultaneous payments and create chaos for the writers.

Stating the obvious

"Credit default swaps, I think, have some serious problems with them."—former Federal Reserve Chairman Alan Greenspan – Testimony to the House Oversight Committee, October 23, 2008[31]

It wasn't just the sophisticated derivative products that led to troubles in 2008. Even relatively benign investments became suspect. Money market accounts were sucked into the whirlpool of doubt due to the other market problems. Money market funds are generally valued at $1 per share and are not subject to FDIC insurance. They are generally believed to be stable value funds that return an interest rate but are not subject to capital erosion risk. However, as a result of the Lehman collapse and market conditions, some funds fell below the $1 per share mark and exacerbated the already turbulent markets. The Treasury announced a temporary program to insure money funds, but the program was limited to shareholders who had money in the funds on September 19, 2008.[32]

28 Fitch Ratings, *Fitch Sees Mounting Pressure on Insurance Ratings Globally*, BUSINESS WIRE, October 17, 2008.

29 Anthony Faiola, Ellen Nakashima, and Jill Drew, *What Went Wrong*, THE WASHINGTON POST, October 15, 2008.

30 Carrick Mollenkamp, Serena Ng, Liam Pleven, and Randall Smith, *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, THE WALL STREET JOURNAL, November 3, 2008.

31 Kara Scannell and Sudeep Reddy, Greenspan *Admits Errors to Hostile House*, THE WALL STREET JOURNAL, October 24, 2008.

32 Sandra Block, *Outlook on Low-risk Investments Not So Bad: Before You Panic, Take a Closer Look at Money Market Funds, Annuities*, USA TODAY, September 23, 2008.

Government response

"There is only so much government can do"—Treasury Secretary Hank Paulson[33]

The mayhem captured the attention of governments around the world. The US federal government attempted to act quickly and consistently throughout the process. However, some saw this multipronged government response as an astonishing expansion of federal involvement in the economy. [34]

Credit default swaps have been targeted for review by both the federal government and state officials. Securities and Exchange Commission (SEC) Chairman Christopher Cox has requested new authority to regulate the credit default swap market. New York State has entered the credit default swap fray by issuing Circular Letter No. 19, which recommends limiting the issuance of policies backing collateralized debt obligations. Additionally, writers of credit default swaps may be considered in the insurance business and may therefore be required to be regulated by the state. The letter also seeks to increase capital requirements for financial guarantors.[35] State regulators will begin regulating credit default swaps as insurance products when the swap purchaser owns the underlying property, and the seller will be required to be a licensed insurer to sell such swaps.[36]

Side Bets and Bucket Shops

"A derivative is a financial instrument whose value is based on something else. It's basically a side bet."—Frank Partnoy, law professor at the University of San Diego. A primitive derivate was used in gaming establishments called "bucket shops" in the early twentieth century. People could place wagers on the movement of stocks up or down without actually owning them. The speculation contributed to the panic and subsequent crash in 1907, and bucket shops were then banned.[37]

The SEC ordered a temporary halt of short selling in shares of 799 financial companies, including scores of insurance companies. This action was done in cooperation with the UK Financial Services Authority. With the market turbulence, the SEC was "committed to using every weapon in its arsenal to combat market manipulation."[38]

33 Richard Wolf, Kathy Kiely, Fredreka Schouten, and John Fritze, Dow Plunges 778; *Parties Point Fingers as Rescue Fails*, USA TODAY, September 30, 2008.
34 David J. Lynch, *Confidence Cracks: Financial System Relies on Faith; Investors and Bankers Have Lost Theirs*, USA TODAY, October 10, 2008.
35 Circular Letter No. 19, State of New York Insurance Department, Re: "Best Practices" for Financial Guaranty Insurers.
36 Judith Barnes, DJ Update: SEC's Cox Seeks Authority Over Credit Default Swaps, DOWJONES NEWSWIRES, September 23, 2008.
37 Franklin L. Devine and Jennifer MacDonald, *The Bet That Blew Up Wall Street*, CBS NEWS, *available at* http://www.cbsnews.com/stories/2008/10/26/60minutes/printable4546199.shtml (last visited Jan. 10, 2009), Oct. 26, 2008.
38 Sean P. Carr, *SEC Halt of Short Selling Includes Several Insurance Stocks*, ADVISEN FPN, September 22, 2008.

Legislatively, Congress has moved forward on several key bills to address these troubling times. In February, the first attempt to right the economic ship was the Economic Stimulus Act of 2008, which was primarily focused on rebate checks and bonus depreciation.[39]

By the time mid-summer rolled around, the foreclosure crisis was continuing to accelerate and bank failures were on the rise. Combined with the implosion of Freddie and Fannie, these factors led to the Housing and Economic Recovery Act of 2008. The bill provides oversight of Fannie and Freddie through the Federal Housing Finance Agency, a newly created independent federal agency. There were also provisions to help homeowners, such as insurance for refined loans for distressed borrowers, and more flexibility for loan servicers to help avoid foreclosure. Tax incentives were also part of the bill, including a $7,500 tax credit for first-time homebuyers, expansion of the low-income housing tax credit, modifications of the Real Estate Investment Trust (REIT) testing rules, and changes to due dates on corporate estimated taxes.[40]

The Economic Stabilization Act of 2008, otherwise known as the “bail-out bill,” almost died before being resurrected and signed by former President Bush. On September 29, the House rejected the first version of the bill amid partisan bickering. Republicans accused House Speaker Nancy Pelosi of engaging in partisan rhetoric as the bill was about to be voted on. However, it was political fear that drove many representatives. The bill was seen as a bail out by the American people who were overwhelmingly against it. Phone calls and e-mails were running 10 to 1 against the bill. Members in hotly contested races in both parties voted against the bill, further contributing to its demise. As a result, the carnage on Wall Street was massive, with the Dow dropping 778 points the following day.[41]

The plummeting markets and a sweetening of the bill with $150 billion in tax breaks and incentives, including an increase in the FDIC insured limit to $250,000, led to the reconsideration of the bill, and former President Bush signed the package into law on October 3, 2008. The bill created the Troubled Asset Relief Program, known as TARP. Under TARP, the Treasury has $700 billion available to purchase toxic assets that are crippling the financial sector. The bill also mandates the government to take equity stakes in companies that participate in TARP and limits executive compensation and golden parachutes.[42]

Flammable fraud

The financial crisis has led to a rise in insurance fraud by those trying to resolve their financial problems by collecting on insurance policies. In Maine, state fire marshals are seeing more buildings and vehicles going up in smoke. The State Fire Marshal’s Office confirmed 134 cases of arson representing $8 million of property.[43]

39 Economic Stimulus Act of 2008, Pub. L. No. 110-185, 122 Stat. 613.

40 Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654.

41 Richard Wolf, Kathy Kiely, Fredreka Schouten, and John Fritze, *Dow Plunges 778; Parties Point Fingers as Rescue Fails*, USA TODAY, September 30, 2008.

42 Greg Hitt and Deborah Solomon, *Historic Bailout Passes As Economy Slips Further*, THE WALL STREET JOURNAL, October 4, 2008.

43 Diana Bowley, *Economy May Be Cause of More Fires ‘Trapped’ People Commit Arson for Insurance Money*, BANGOR DAILY NEWS, December 22, 2008.

The Federal Reserve and Treasury Department acted decisively in response to the crisis. The Fed loaned funds as necessary to entities far beyond the traditional banks, including investment banks and insurance companies. The Treasury Department is moving nimbly to carry out TARP, although its plan appears to be in constant motion.

Accounting standard setters in the United States and abroad took to the stage to respond to the crisis. The leaders of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have said the crisis reinforces the idea that the world is globally interconnected and that global solutions are required. The IASB is under pressure to allow reclassification of financial instruments in accordance with US GAAP so European Union (EU) companies would have the same reclassifications as their US counterparts and encourage consistency.[44] On October 7, the EU finance ministers agreed to adopt fair value accounting rules similar to the US SEC's rules.[45] The director of the FASB Suzanne Bielstein said it is "very important to strengthen the IASB and make it independent and sustainable."[46]

Consistent messages on both sides of the pond

The global financial crisis has "impacted everything" and "clearly… reinforces the idea that we have a globally interconnected set of financial markets and economies."—FASB Chairman Robert Herz

"It is a clear sign—we have to have the same standards on both sides of the Atlantic."—IASB Chairman David Tweedie[47]

44 Joyce E. Cutler, *Worldwide Financial Crisis Underscores Need for Global Standards, Accounting Chiefs Say*, BNA DAILY TAX REPORT, October 27, 2008.

45 Joe Kirwin, Joe *EU Finance Ministers Agree to Adapt US Rules in Effort to Stabilize Financial Markets*, BNA DAILY TAX REPORT, October 8, 2008.

46 Steve Burkholder, *Credit Crisis Shows Need for Independent Rule Making, FASB Staff Director, Analyst Say*, BNA DAILY TAX REPORT, October 29, 2008.

47 Joyce E. Cutler, *Worldwide Financial Crisis Underscores Need for Global Standards, Accounting Chiefs Say*, BNA DAILY TAX REPORT, October 27, 2008.

Chronology of an economic crisis

1. February 28, 2007 – Ben Bernanke told the House Budget Committee he didn't consider the housing issues as "being a broad financial concern or a major factor in assessing the state of the economy.
2. August 3, 2007 – The Dow fell 300 points, the day after American Home Mortgage announced it was shutting down.
3. August 9, 2007 – BNP Paribas, a major French bank, temporarily suspended withdrawal from three of its investment funds.
4. February 13, 2008 – Former President Bush signed the Economic Stimulus Act of 2008.
5. July 13, 2008 – Treasury Secretary Paulson told reporters he would request authority from Congress to inject an unspecified amount of money into Fannie and Freddie to stabilize the companies.
6. July 30, 2008 – Former President Bush signed the Housing and Economic Recovery Act of 2008.[48]
7. September 15, 2008 – Lehman Brothers filed for bankruptcy.[49]
8. September 16, 2008 – Reserve, Primary Fund, a New York money market mutual fund "broke the buck" and suspended redemptions because its net asset value had fallen below a dollar per share. This sparked an investor panic with global ramifications.
9. September 16, 2008 – The government announced the $85 billion emergency loan to AIG in return for a 79.9 percent stake in the company.[50]
10. September 19, 2008 – The Bush administration announced a plan to allow the government to buy $700 billion of toxic assets.
11. September 25, 2008 – JP Morgan Chase bought Washington Mutual assets after FDIC seized WaMu.
12. September 28, 2008 – Congressional leaders and the White House agreed to a $700 billion rescue of financial industry.
13. September 29, 2008 – The House rejected the first version of the bailout plan. The Dow posted its largest ever single-day point drop of 778 points.[51] The same day, Citigroup set a deal to purchase Wachovia.
14. October 1, 2008 – The revised bailout bill with more than $100 billion in incentives is passed in the Senate. The bill also raised the FDIC limit to $250,000.
15. October 3, 2008 – The House passed the bailout bill and it was signed into law. Wells Fargo entered the fray with its $15.1 billion bid for Wachovia.
16. October 8, 2008 – The federal government lent AIG an additional $38 billion.
17. October 14, 2008 – The Treasury Department allowed the government to purchase stakes in banks.
18. November 10, 2008 – The Federal Reserve and Treasury revisited AIG's aid and agreed to invest $150 billion, $40 billion of which is preferred stock that pays an annual dividend.[52]
19. November 12, 2008 – Government Toxic Asset plans were changed. The government does less risky-asset purchasing and more direct bank stock purchases.
20. November 17, 2008 –The terms of the AIG assistance program were modified. A $40 billion equity investment under TARP and a five-year credit facility of $60 billion are among the new features.[53]
21. November 23, 2008 – The government injected $20 billion into Citigroup in attempt to further stabilize the company. Previously, the company had received $25 billion from TARP.[54]
22. December 20, 2009 – The Bush administration lent General Motors and Chrysler $17.4 billion to help shore up the companies.[55]

48 Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654.
49 John Cassidy, *Anatomy of a Meltdown: Ben Bernanke and the Financial Crisis*, THE NEW YORKER, December 1, 2008.
50 Barbara Hagenbaugh and Sue Kirchhoff, *Rescue Revamp: Where Will What's Left of the Bailout Plan's $700 Billion Go?*, USA TODAY, November 13, 2008.
51 Richard Wolf, Kathy Kiely, Fredreka Schouten, and John Fritze, *Dow Plunges 778; Parties Point Fingers as Rescue Fails*, USA TODAY, September 30, 2008.
52 *Id.*
53 Alyn Ackerman, *AIG's New Deal Draws Mixed Reviews*, BEST'S INSURANCE NEWS, November 17, 2008.
54 Jeannine Aversa, *Government Unveils Bold Plan to Rescue Citigroup*, THE ASSOCIATED PRESS, November 24, 2008.
55 John D. McKinnon and John D. Stoll, *U.S. Throws A Lifeline To Detroit*, THE WALL STREET JOURNAL, December 20, 2008.

The 2008 elections

Presidential election

In many ways, the 2008 Presidential campaign was a historical event. The field started with 16 candidates from the two parties and quickly dwindled down to three major candidates, 2 Democrat, 1 Republican. The Democratic contenders, Hillary Clinton and Barack Obama each represented a historic moment for the nation; either the first woman or the first African American would capture a major party's nomination for the presidency. By summer, Barack Obama emerged from the Democratic primary victorious. John McCain, the Republican, seemed poised to dominate the foreign policy debate. With the selection of the vice presidential candidates, Senator Joe Biden and Alaska Governor Sarah Palin, the fun really began.

The Wall Street meltdown quickly became the focal point of the election; both candidates shifted their focus to economic issues, with John McCain even suspending his campaign for a few days to return to Washington, DC to work on solutions. Ultimately, it was Barack Obama's message of change that won the majority of the electorate.

Mr. Obama has significant policy objectives to achieve his campaign promises. His initial goals will focus largely on economic issues as he seeks to revitalize the economy. According to Mr. Obama's transition website, www.change.gov, the plan has four major components: (1) immediate action to create good jobs in America; (2) immediate relief for struggling families; (3) direct, immediate assistance for homeowners; not a bailout for irresponsible mortgage lenders; and (4) a rapid, aggressive response to our financial crisis, using all the tools we have.[56]

Mr. Obama's economic plans include:

- Assistance for homeowners, including instruction to the Treasury and Housing secretaries to more aggressively modify mortgage terms and remove legal impediments to broader mortgage restructuring
- Broader credit assurances to banks as necessary, and extending to small businesses and state and local governments, as necessary
- Asset purchases similar to TARP for other critical sectors of the economy

Mr. Obama proposes several tax ideas to correlate with his economic plans:

- New American Jobs Credit – A temporary tax credit for companies that add jobs in the United States. The proposed figure is $3,000 a year for 2009 and 2010 for each additional full-time employee hired.
- Several provisions for small businesses, including enhanced 179 deductions and limitations on capital gains income for small businesses
- Individual solutions, including tax cuts for many Americans, extended unemployment benefits, easing of penalties on withdrawals from tax-favored accounts[57]

56 http://change.gov/agenda/economy_agenda/, December 8, 2008.
57 *Id.*

In early 2009, Mr. Obama proposed a $300 billion tax cut as part of his recovery plan.[58] Included in the plan is a refundable tax credit to compensate for the regressive nature of the payroll tax and a one-year credit to businesses that make new hires or avoid layoffs. Additional help in the package for businesses includes an extension of bonus depreciation and an increase in the carryback period for net operating losses in 2008 and 2009 to five years.

Obama's other major campaign promise was to reform the healthcare system of the country. He ran on broad promises of access to affordable healthcare as a right for all Americans. The pillars of the plan include:

- Require insurance companies to cover preexisting conditions so all Americans, regardless of their health status or history, can get comprehensive benefits at fair and stable premiums.
- Create a new small-business health tax credit to help small businesses provide affordable health insurance to their employees.
- Lower costs for businesses by covering a portion of the catastrophic health costs they pay in return for lower premiums for employees.
- Prevent insurers from overcharging doctors for their malpractice insurance and invest in proven strategies to reduce preventable medical errors.
- Make employer contributions fairer by requiring large employers that do not offer coverage or make a meaningful contribution to the cost of quality health coverage for their employees to contribute a percentage of payroll toward the costs of their employees' healthcare.
- Establish a National Health Insurance Exchange with a range of private insurance options as well as a new public plan based on benefits available to members of Congress that will allow individuals and small businesses to buy affordable health coverage.
- Ensure everyone who needs it will receive a tax credit for their premiums.

These ideals may be delayed in whole or in part by the economic downturn. However, other senators are jumping on the healthcare bandwagon. Senate Finance Chairman Max Baucus held a conference in November to unveil his "Call to Action: Health Reform 2009."[59]

High expectations for President Obama

"The pressure on Obama to deliver instantly is going to be enormous. People want this to be a time of unity, of coming together, and of consensus."[60]—Robert Dallek, Presidential Scholar

Key to his ability to achieve his economic goals is his economic team. The team starts with Treasury Secretary nominee Timothy Geithner. Mr. Geithner is the president of the Federal Reserve Bank of New York and has worked closely with former Treasury Secretary Hank Paulson on solutions to the current economic crisis.[61] He came under fire early about questions surrounding payment of federal taxes.

58 Sam Goldfarb, *Obama Proposing $300 Billion in Tax Cuts For Recovery Plan*, TAX ANALYSTS, 2009 TNT 2-1, January 6, 2009.

59 Congressional Research Service, *Baucus To Unveil 2009 Health Reform Plans*, available at TAX ANALYSTS, November 7, 2008.

60 Kenneth Walsh, *Can Obama Truly Deliver? The President Elect Must Guide the Country Through Trying Times*, U.S. NEWS AND WORLD REPORT, November 17-25, 2008.

61 Staff writers, *Obama's Economic Team*, CHICAGO SUN TIMES, November 25, 2008.

The nominee for director of the National Economic Council, Lawrence Summers, is an economist from Harvard and spent five years as the president of the school. As Treasury Secretary to President Clinton, he argued that Fannie and Freddie should be required to meet oversight and capital requirements. The head of the White House Domestic Policy Council will be Melody Barnes, former chief counsel for Edward Kennedy. Christina Romer was picked to chair the White House Council of Economic Advisors. She is an economics professor at the University of California at Berkeley and a student of the Great Depression.[62]

Speedy transition: Obama names majority of administration officials quickly[63]

Mr. Obama has wasted no time in naming the key figures of his administration:

Secretary of State	Hillary Clinton
Secretary of Commerce	Bill Richardson (withdrawn)[64] – a new candidate has not been named
Attorney General	Eric Holder
Secretary of Defense	Robert Gates (Republican)
Secretary of Labor	Hilda Solis
Secretary of Housing and Urban Development	Shaun Donovan
Secretary of Health & Human Services	Kathleen Sebelius
Secretary of the Treasury	Timothy Geithner
Secretary of Homeland Security	Janet Napolitano
Economic Recovery Advisory Board	Paul Volcker
Federal Deposit Insurance Corporation	Not yet named
Office of Management & Budget	Peter Orszag

Congressional election

The 2008 Congressional elections increased the Democratic Party's previous majorities. The House Democratic majority is now 256-178,[65] and the Democratic Senate majority is now 58-41, with Minnesota election still undecided and headed to court.[66] In the Senate, the Democratic Party is very close to achieving a filibuster-proof majority of 60 seats. The filibuster is a tool used to kill bills by essentially talking them to death. Any senator may go to the floor for unlimited debate on any topic, thereby stalling it indefinitely. A two-thirds majority is required for cloture, or the cutoff of the debate, so the legislative process may continue.[67]

62 *Id.*
63 Jonathan Weisman, *Obama Sets Fast Pace for Transition*, THE WALL STREET JOURNAL, December 22, 2008.
64 Michael D. Shear and Carol D. Leonnig, *Commerce Pick Richardson Withdraws, Citing N.M. Probe*, THE WASHINGTON POST, January 5, 2009.
65 As of January 30, 2009, the Fifth District of Illinois is vacant as the former Rep. Rahm Emanuel has become White House Chief of Staff.
66 Brian Bakst, *1st Major Hearing in Minn. Senate Lawsuit Set for Next Week*, AP NEWSWIRE, January 16, 2009.
67 Answers.com, *Filibuster*, US Government Guide, http://www.answers.com/topic/filibuster#US_Government_Guide, December 22, 2008.

Did you know?

The word "filibuster" comes from Dutch for "pirate." The term became popular in the United States in the 1850s when American adventurers tried to overtake various Caribbean Islands. The term was soon applied to rogue congressmen trying to seize power from the majority.[68]

Both financial services and healthcare reform are at the top of the legislative agenda. Several Congressional newcomers could shape insurance industry legislation, and it remains to be seen if these members will be friend or foe to the industry:[69]

- Representative Blaine Luetkemeyer (R-MO) – Former independent agent and served as state finance examiner
- Representative Bill Posey (R-FL) – Previously tangled with the insurance industry as Chairman of the Florida Senate Committee on Banking and Insurance and worked on 2007 legislation expanding the state's catastrophe fund
- Representative Steve Driehaus (D-OH) – Pushed for legislation for committee oversight of Ohio's state investment decisions and supports an expansion of the State Children's Health Insurance Program (SCHIP)
- Representative Ben Ray Lujàn (D-NM) – Chaired New Mexico Public Regulation Commission, which oversees the Division of Insurance, and tangled with both title insurance reinsurance and health insurance companies
- Senator Tom Udall (D-NM) – Pledged to make health insurance a priority, beginning with the expansion of SCHIP
- Senator Mike Johanns (R-NE) – Former governor of Nebraska, has significant experience with crop insurance

Painful prediction

"The first six months of '09 will be very painful, the second six months will just be painful, and 2010 will be uncomfortable."—Mark Zandi, Moody's Economy.com Chief Economist[71]

Looking forward

The financial services industry will continue its wild ride of activity as other entities survive or fail in the current climate. Turmoil is causing banks to reduce work forces and employ other cost-cutting measures.[70] Governments and accounting boards will continue to impose new laws, regulations, and standards in an attempt to tighten controls.

There are many proposed solutions to the economic ills. Pressure will continue to mount from a variety of special interest groups, industry groups, attorneys, accountants, and everyday citizens for government to act quickly and bring back sunny economic times. However, the solutions may be just as difficult as the malady itself. Ben Bernanke is endorsing another round of economic stimulus. "With the economy likely to be weak for several quarters, and with some risk of a protracted slowdown, consideration of a fiscal packaged by the Congress at this time seems appropriate," Bernanke told Congress.[72]

68 *Id.*

69 R.J. Lehmann, *New Faces Could Play Role in Landmark 111th Congress*, BEST INSURANCE NEWS, November 17, 2008.

70 John W. Molka III, *Commercial Banks, Thrifts and Mortgage Finance Industry Abstract*, July 2008, ADVISEN FPN, September 22, 2008.

71 Barbara Hagnbaugh, *2009: How Long Will the Economic Plunge Go On? Most Experts Don't See Recovery Coming Until Late in the New Year*, USA TODAY, December 23, 2008.

72 Brett Ferguson, *Bernanke Endorsement Gives Momentum to Idea of 'Second Stimulus' Package*, BNA DAILY TAX REPORT, October 21, 2008.

One expected action in the United States is that premiums for the FDIC general deposit insurance fund are expected to increase, as the fund has fallen below the minimum standards set for it by Congress.[73] Congress and the IRS will also be on the hunt for tax dollars. When setting exam priorities, the IRS will consider the transactions, parties, and conditions of the transactions.[74] The IRS has also indicated it will work to gather and share more information about taxpayers with foreign governments.[75] The LMSB Financial Services Industry Director Walter Harris said, "the upcoming year for us is going to be one of the most challenging years for the financial services industry … The bottom line for us is we… need to understand what the economic realities are, the economic relationships are, and what is happening today, even though today for us sometimes is yesterday."[76] The IRS has already indicated its investigations of US taxpayers hiding assets in foreign banks are "far from over."[77]

UBS tax-evasion problems spur account closings

Amid investigations from a Senate subcommittee and the Justice Department for aiding US clients to evade taxes, Swiss bank UBS has begun closing down various offshore banking services for 19,000 US-based clients.[78]

The 2008–2009 Priority Guidance Plan has several items of interest for the insurance industry as well:[79]

- Final regulations on the exchange of property for an annuity contract
- Guidance concerning the partial exchange or partial annuitization of an annuity contract
- Guidance on employer-owned life insurance contracts under Section101(j)
- Guidance on the classification of certain cell captive insurance arrangements. Previous guidance was published in Notice 2008-19
- Revenue ruling providing guidance on reinsurance arrangements entered into with a single ceding company
- Guidance on tax issues arising under Section 807 as a result of the adoption by the National Association of Insurance Commissioners (NAIC) of an Actuarial Guideline setting forth the Commissioners' Annuity Reserve Valuation Methodology for variable annuities (AG VACARVM)
- Revenue ruling regarding the tax-free exchange of life insurance contracts subject to Section 264(f)
- Guidance on the determination of the company's share and policyholders' share of the net investment income of a life insurance company under Section 812
- Final regulations concerning information reporting on employer-owned life insurance contracts under Section 6039I

73 Sandra Block, *JP Morgan Scoops Up WaMu Assets for $1.9B: FDIC Promises Transition Will Be Seamless for Bank's Customers*, USA TODAY, September 26, 2008.
74 Stephen Joyce, *IRS Speakers Say Current Financial Tumult Leading to More Examination Challenges*, BNA DAILY TAX REPORT, October 29, 2008.
75 Sam Young, *IRS Grapples With International Tax Compliances in Globalized Economy, Officials Say*, TAX ANALYSTS, 2008 TNT 69-5, April 9, 2008.
76 *Id.*
77 Allison Bennett, *Tax Havens: Shott Says Investigations of U.S. Taxpayers Hiding in Foreign Banks Not Over*, BNA Daily Tax Report, October 29, 2008.
78 David D. Stewart, *Swiss Bank Closing US Clients' Accounts*, TAX ANALYSTS, 2009 TNT 6-10, January 12, 2009.
79 Office of Tax Policy and Internal Revenue Service, *2008–2009 Priority Guidance Plan*, September 10, 2008.

And despite the economic woes, Congress still found time to put the spotlight on offshore insurance companies with the Neal Reinsurance Bill.[80] With the hunt for revenue on by taxing authorities, this trend is likely to continue.

The insurance industry controversy regarding federal regulation of insurance operations will likely be a hot topic of debate, with the outcome affecting the industry for decades to come.[81]

2008–2009 Guidance Priority List

On May 30, 2008, the American Council of Life Insurers (ACLI) requested items be added to the IRS's 2008–2009 Guidance Priority List, including:

- Additional guidance regarding corporate-owned life insurance covered by Section 863 of the Pension Protection Act of 2006, possible tax implications of reserve modification proposals relating to actuarial guidelines for reserves for variable annuity contracts and life insurance contracts, and what the term "statutory reserves" means for the purposes of Section 807 in cases where different states subject life insurance companies to different statutory requirements
- Guidance clarifying the tax treatment of the "direct partial annualization" of a "nonqualified" deferred annuity contract under Section 72, allowing investment in separate account products of a Section 953(d) company, and updating life/nonlife consolidated return regulations
- Final regulations expanding the list of holders whose beneficial interest in an investment company, partnership, or trust do not prevent segregated asset accounts from looking through to the assets of the investment company, partnership, or trust to satisfy Section 817(h) requirements[82]

In addition, on behalf of the Committee of Annuity Insurers, Davis & Harman LLP requested guidance on (1) the extension of special rules in Treas. Reg. Section 1.817-5(f)(3)(vi) to segregated asset accounts of Bermuda life insurers who elect to be treated as a domestic corporation for US tax purposes under Section 953(d) and insurance companies of any other foreign country that the Secretary of the Treasury identifies in future guidance; and (2) the measures required to verify that a person is a permitted investor as described in Treas. Reg. Section 1.817-5(f)(3), including the result in the cases of incorrect determinations.[83]

80 H.R. 6969.

81 Eric Arnold, *Impact of the Emergency Economic Stabilization Act and Related Developments on Insurance Companies*, MONDAQ BUSINESS BRIEFING, November 14, 2008.

82 Walter Welsh; William Elwell; and Mandana Parsazad, *ACLI Identifies Insurance Issues for Guidance Priority List*, 35 INS. TAX REV. 443 (2008).

83 Joseph F. McKeever, III; Mark E. Griffin; and Bryan W. Keene, *Firm Seeks Guidance on Tax Treatment of Partial Annuitization of Non-Qualified Deferred Annuity Contracts*, TAX NOTES TODAY, 2008 TNT 117-28, May 30, 2008.

Accounting standard setters are also debating a variety of issues to implement in the coming year. The FASB has added a joint project with the IASB for consistency in accounting for insurance contracts.[84] The Public Company Accounting Oversight Board (PCAOB) Chairman Mark Olson is encouraging the PCAOB to coordinate with its foreign counterparts.[85] This is in conjunction with the SEC approval of the roadmap for the use of IFRS by US companies and general consensus that a uniform standard of accounting is needed across the United States and other countries. The conversion to IFRS will continue to be a developing issue for insurance companies as the conversion process continues over the next several years. Several key tax differences between US GAAP and IFRS will need to be resolved, including the accounting for tax uncertainties, share-based payments, intercompany transactions, and intraperiod allocations.[86]

The future is expected to be challenging for the insurance industry. Investment losses will hurt annuities and life insurance companies.[87] Statutory capital levels have fallen significantly. Hurricane Ike and other disasters hurt property and casualty companies. A glimmer of hope is the slight improvement in property and casualty insurance pricing after deterioration over the last few years. These challenges will test the industry.

Troubled waters ahead

Researchers at Colorado State University are predicting a busy hurricane season for 2009. They are expecting 14 named storms, 7 hurricanes and 3 major hurricanes. An average season from 1950 to 2000 included 9.6 named storms, about 6 hurricanes, 2.3 of which were major storms.[88]

American Recovery and Reinvestment Act of 2009[89]

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009, beginning the process of injecting $787.2 billion into the economy. The President called the bill "the most sweeping economic recovery package in our history," arguing that it would provide not only a temporary boost to the economy but also set the stage for long-term growth. The legislation includes about $290 billion in tax incentives, none of which directly impacts the insurance industry.[90] However, a previous version of the legislation included a provision that would have increased the net operating loss carryback period for life insurance companies from three to five years. The current legislation limits the 5-year NOL carryback only to small companies with gross receipts of less than $5 million.

84 Denise Lugo, *Herz Says FASB Will Pursue Project on Insurance Contracts Jointly with IASB,* BNA DAILY TAX REPORT, October 31, 2008.
85 Martha Kessler, *PCABO Chairman Says Board's Reach Should Go Beyond U.S. Shores*, BNA DAILY TAX REPORT, October 30, 2008.
86 Allison Bennett, *Tax Uncertainties Likely to Be Major Issue in U.S. GAAP, IFRS Convergence, Panel Says*, BNA DAILY TAX REPORT, June 16, 2008.
87 Neena Mishra, *U.S. Insurance Industry*, ADVISEN FPN, Zacks.com, January 5, 2009.
88 Chad Hemenway, *Three Major Hurricanes Predicted for 2009 Season*, ADVISEN FPN, December 11, 2008.
89 H.R. 598
90 Goldfarb Sam, Obama Signs 'Sweeping' Stimulus Bill With Billions in Tax Relief, Tax Analysts, 2009 TNT 30-1, February 18, 2009.

02

Legislation

Introduction

2008 proved to be among the worst financial years on record. As the year progressed, the economy worsened and global markets felt the effects. Iceland went bankrupt![1] The financial crisis transcended many borders, and former President Bush hosted a G-20 World Summit in Washington on November 15 to coordinate a response to a problem that affected most developed countries.[2] By year end, home foreclosures, deemed to be at the root of the problem, grew to a staggering 3 percent of all households;[3] over 25 banks failed;[4] and global icons such as AIG, Citibank, and major US automakers lined up to ask for government assistance just to stay afloat. Some, like Lehman Brothers, simply went bankrupt. Still others, such as Merrill Lynch and Bear Stearns, had to be rescued by stronger competitors.[5]

As a result of the financial crisis, Congress spent the year focused on the economy, and not much else. Between hearings to determine what caused it, how to remedy it, and the usual across-the-aisle finger pointing as to who was to blame for it, not much was accomplished. Action came early on in February in the form of the Economic Stimulus Act of 2008, which by all accounts provided very little stimulus. This was followed up by July's Housing and Economic Recovery Act of 2008. The economy did not recover. The Emergency Economic Stabilization Act of 2008, which passed in October, did not stabilize the economy, but this legislation did allow for the extension of several expiring tax provisions, including the Subpart F active financing exception. Even before he took office, President Obama met with Congressional leaders to discuss an additional economic recovery spending and tax stimulus package of approximately $825 billion.[6]

Some in the industry worry that amid the worst financial crisis in decades, a crisis which took the full attention of Congress, some members still found time to craft legislation to limit tax deductions associated with offshore reinsurance. Companies such as ACE Ltd. and Tyco International Ltd., among others, redomesticated from Bermuda to Switzerland.[7] Nontax reasons were cited. Interest in foreign reinsurers and other potential revenue-raisers is sure to pick up momentum in 2009 as Congress eventually renews its focus on deficit control.

1 Michael Mandel, *Iceland Goes Bankrupt*, BUSINESS WEEK, October 10, 2008.
2 *G20 Leaders Promise Action on Economic Crisis*, CBC NEWS, November 15, 2008.
3 Stephen Gandel, *Treasury Plans for Mortgage Rates Could be Costly*, TIME, December 5, 2008.
4 FDIC Failed Bank List, *available at* www.fdic.gov, December 31, 2008.
5 *Wall Street Scrambles as Lehman Merrill, Falter, available at* www.msnbc.com, September 15 2008.
6 Henry J. Pulizzi, *Obama Pitches Stimulus Plan, Warns of Lingering Recession*, THE WALL STREET JOURNAL, January 16, 2009.
7 Ben Casselman and Jesse Drucker, *Swiss Gain as Tax Plan Dims Bermuda's Allure*, THE WALL STREET JOURNAL, December 12, 2008.

Enacted legislation

Economic Stimulus Act of 2008

On February 13, 2008, former President Bush signed the $152 billion Economic Stimulus Act of 2008 (ESA), which primarily included tax rebates for individuals and accelerated depreciation for businesses.[8] The ESA allows an additional 50 percent first-year bonus depreciation for assets acquired and placed into service in 2008. Eligible property includes tangible property with a recovery period not exceeding 20 years, purchased computer software, water utility property, and qualified leasehold improvement property.

Bonus depreciation: Existing bonus depreciation rules under Section 168(k) were modified by changing the effective dates to January 1, 2008 and December 31, 2008. Eligible property must be placed in service on or after January 1, 2008 and on or before December 31, 2008. An extended placed-in-service date of December 31, 2009 is available for long-production-period property, certain transportation property, and certain aircraft. Accordingly, taxpayers had an incentive to purchase equipment and reconstruct offices in 2008.

Since Congress waived the "pay-as-you-go" budget rules for the emergency legislation, the ESA did not contain any business tax increases or other revenue-raising tax provisions to offset the estimated revenue loss.

The Housing and Economic Recovery Act of 2008

On July 30, 2008, former President Bush signed the Housing and Economic Recovery Act of 2008 (HERA) into law.[9] Despite the absence of insurance tax-specific provisions, the HERA reforms several financial services industry regulations and includes tax incentives to help boost the housing market.

Reform of regulation of enterprises: The legislation establishes the Federal Housing Finance Agency (FHFA) as an independent agency of the federal government. The FHFA director will have authority over Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and the Office of Finance. The HERA also establishes a Federal Housing Finance Oversight Board to advise the director with respect to overall strategies and policies in carrying out the director's duties as defined under the HERA.

Hope for homeowners: This provision establishes a Hope for Homeowners Program (H4H), under the Federal Housing Administration (FHA), to insure refinanced loans for distressed borrowers to support long-term, sustainable homeownership; allow homeowners to avoid foreclosure by reducing the principle balance outstanding and interest rate charged on their mortgages; help stabilize and provide transparency in the value of mortgage-backed assets; enhance the administrative capacity of the FHA to carry out its expanded role under the H4H; provide stability to the housing market; and provide expanded options to help avoid foreclosure of delinquent mortgages.

8 Economic Stimulus Act of 2008, Pub. L. No. 110-185, 122 Stat. 613; *President Signs Economic Stimulus Act of 2008 With Rebates And Business Incentives*, CCH TAX BRIEFING: ECONOMIC STIMULUS PACKAGE, February 13, 2008.

9 Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289.

Housing tax incentives: This provision provides a $7,500 tax credit for first-time home buyers, provides a new state and local property tax standard deduction for nonitemizers, and also features language to expand and improve the availability of the low-income housing tax credit (LIHTC). Other low-income housing incentives include a temporary $0.20 percent per capita increase in Housing Credit Authority for 2008 and 2009 with a 10 percent increase to the small state minimum; an alternative minimum tax (AMT) exemption for LIHTC investments; and the replacement of the LIHTC recapture bond requirement with a reporting requirement. The changes also temporarily fix the annual LIHTC rate at 9 percent and allow a 30 percent increase in eligible basis for properties determined by state agencies.

Reforms related to real estate investment trusts (REITs): The HERA revises the REIT income and asset tests and includes provisions to address changes to the holding period and sales value determination for safe harbors as well as conformity for healthcare REITs.

Revenue raisers: Some of the revenue offsets in the HERA include a provision requiring information to be reported from credit card companies and other third-party payment processors on merchants with annual sales in excess of $20,000 or with a volume of more than 200 sales. The legislation also delays implementation of the worldwide interest allocation provision from December 31, 2008 to December 31, 2010; excludes gains from the sale of certain residences; and makes changes to the payment due date for corporate estimated taxes.

Other highlights: The HERA repeals the AMT limitations on tax-exempt housing bonds, the LIHTC, and the rehabilitation credit; increases the volume cap rules on private activity bonds by $11 billion; relaxes mortgage revenue bond limitations on providentially declared disaster areas; and allows for a $1.3 billion expansion of certain Gulf Opportunity Zone incentives.

Emergency Economic Stabilization Act of 2008

On October 3, 2008, former President Bush signed the Emergency Economic Stabilization Act of 2008 (EESA), authorizing the Treasury Department to purchase the troubled assets of financial institutions, among other provisions.

Troubled Assets Relief Program (TARP): The EESA establishes standards for executive compensation and corporate governance for financial institutions that sell troubled assets directly to the government or receive a capital infusion from the government. When auction purchases of troubled assets (including direct purchases) exceed $300 million per financial institution, the institution cannot enter into any new employment contract that provides golden parachutes to a senior officer in the event of the executive’s involuntary termination or the bankruptcy, insolvency, or receivership of the institution. For auction purchases, the deduction for certain compensation payments is limited to key employees of participating financial institutions. The Section 162(m) $1 million limit on deductible compensation is reduced to $500,000 for compensation paid to five key executives, and the performance-based pay exclusion is eliminated.

Offshore deferred compensation: Under Section 457A, any compensation deferred under a nonqualified deferred compensation plan of a nonqualified entity must be included in income when there is no substantial risk of forfeiture. Any undeterminable compensation is included in income when it later becomes determinable and is subject to a 20 percent penalty. The provision is effective for amounts deferred for services performed after 2008.

This provision will apply to employees of any corporation or partnership located in a country that does not have an income tax treaty with the United States and also lacks a “comprehensive income tax” regime, unless substantially all of the employer’s income is effectively connected with the conduct of a US trade or business. Whether the provision applies depends upon the location of the entity that is providing the deferred compensation (i.e., sponsoring the deferred compensation plan). The offshore deferred compensation provisions generally apply to any arrangement covered by Section 409A, as well as stock appreciation rights. However, stock options are not covered.

Subpart F active financing exception, controlled foreign corporation (CFC) look-through rule: The EESA extends through the end of 2009 both the Subpart F exception under Section 954(h) for active financing income of foreign subsidiaries (as well as the exception for insurance income under Sections 953(e) and 954(i)) and the look-through treatment under Section 954(c)(6) of payments of interest, rents, and royalties between related CFCs for purposes of the foreign personal holding company income rules.

Research credit extension and modifications: The EESA extends the expired Section 41 research credit retroactively to January 1, 2008 for two years (through December 31, 2009), modifies the Alternative Simplified Credit (ASC), and terminates the Alternative Incremental Research Credit (AIRC) for taxable years beginning after December 31, 2008.

Renewable energy incentives: The EESA extends many of the Section 45 and 48 renewable energy credits for wind, solar, water, geothermal, biomass, fuel cell, microturbine, and other energy sources. New incentives have been added for combined heat and power systems as well as for “smart meters” and “smart grid systems,” which can help optimize a property’s energy use. In addition, public utilities that invest in solar energy now can qualify for the Section 48 credit. The extensions of the Section 48 credits are also available for AMT purposes.

IRS administrative guidance

The IRS issued several notices providing guidance to further interpret the EESA with respect to Section 382 loss deductions, access to the CFC funds, and executive compensation.

Under Notice 2008-83, for purposes of Section 382(h), any deduction properly allowed after an ownership change to a bank with respect to losses on loans or bad debts is not treated as a built-in loss or a deduction attributable to periods before the change date. In Notice 2008-76, the IRS also provided special rules regarding the application of Section 382 in certain acquisitions pursuant to the HERA that are directly related to the government's takeover of Fannie Mae and Freddie Mac.

To help mitigate the liquidity crisis, the IRS issued Notice 2008-91 to ease the rules under which corporations can access funds held by their CFCs without negative tax consequences. The notice provides temporary relief for corporations experiencing difficulty in funding their operations through commercial paper issuances or other third-party borrowings and who therefore need to access funds held by their CFCs. Relief is limited to loans that are actually repaid after no more than 60 days.

In Notice 2008-94, the IRS provided guidance under Sections 162(m)(5) and 280G(e), which were added to the EESA to provide additional limitations on the deductibility of compensation paid to certain executives by employers who sell assets in the TARP. Section 162(m) can no longer be avoided by deferring payments until an individual retires, as the time at which compensation is paid by the institution is no longer important. Section 280G(e) expands the definition of a parachute payment to include certain payments made contingent upon an applicable severance from employment.

In a letter to Treasury Secretary Hank Paulson and Federal Reserve Chairman Ben Bernanke, Senator Charles Grassley (R-IA) asked for a detailed explanation of why the officials believed that additional limitations on executive compensation would cause the program to fail and a detailed description of how companies rescued by TARP would be required to "tighten their belts."

Noteworthy legislation not enacted

Neal foreign reinsurance tax bill

Representative Richard Neal (D-MA) introduced H.R. 6969 to reflect his concern that affiliated reinsurers are being used by US insurers to migrate US insurance risks to offshore reinsurance markets so as to avoid US tax. Under H.R. 6969, the deduction for a portion of reinsurance premiums paid to affiliates would be disallowed.

Generally, the bill would disallow any deduction to covered insurance companies for excess reinsurance premiums with respect to US risks paid to affiliated insurance companies that are not subject to US income taxation. Excess reinsurance premiums are those premiums paid to affiliates during the taxable year by a covered insurance company in excess of the sum of (1) the premium limitation and (2) qualified ceding commissions with respect to such premiums.

For the purposes of this bill, a covered insurance company would include any company subject to tax imposed by Section 831. A qualified ceding commission would be determined as a portion of the ceding commissions paid to a covered insurance company (and that was included in its income) with respect to the affiliated nontaxed reinsurance premiums paid by the covered insurance company during the taxable year. This portion would be determined by the ratio of (1) the amount of affiliated nontaxed reinsurance premiums paid by the company during the taxable year that exceeded the premium limitation for that year to (2) the aggregate amount of affiliated nontaxed premiums paid by the company that year.

A corporation is treated as an affiliated corporation with respect to a covered insurance company if both corporations are members of the same controlled group of corporations. For this purpose, a controlled group of corporations is defined as in Section 1563(a), except the standard used is “more than 25 percent” of the total vote or value of shares rather than “at least 80 percent.”

According to the bill, the premium limitation would be determined by comparing a covered insurance company’s reinsurance with an industry average amount of reinsurance based on an industry fraction determined and published on the basis of published aggregate data from annual statements of insurance companies by the Treasury Department for each calendar year. An industry fraction would determine the allowable amount of affiliate reinsurance. The determination of the industry fraction would be made separately by line of business. The legislation would disallow entirely the deduction for reinsurance premiums paid to an affiliated corporation if the company’s reinsurance premiums paid to corporations that were not affiliated exceeded the amount of the company’s premium limitation for that line of business.

A foreign corporation may elect under Section 953(d) to be treated as a domestic corporation for US income tax purposes. Thus, any foreign corporation that may be affected by the provision is assured that it will, if it so chooses, be treated in the same manner as any US corporation.

Growth of offshore affiliates?

According to Rep. Neal, the market share of offshore affiliates' direct premiums more than doubled from 5.1 percent to 10.9 percent, including the growth of the Bermuda-based share from 0.1 percent to 4 percent. Neal stated the bill would significantly impact the market advantage enjoyed by foreign reinsurers and suggested that the percentage of premiums ceded to affiliates of non-US-based companies grew from 13 percent to 67 percent.[10]

The bill is supported by the Coalition for a Domestic Insurance Industry, who argued that favorable tax treatment in jurisdictions such as Bermuda and the Cayman Islands makes it increasingly difficult for US firms to compete. However, Nancy McLernon, President and CEO of the Organization for International Investment said, "with the current US financial market turmoil—including the US government takeover of the country's largest insurer—this is a dangerous proposal that fundamentally limits capital available to US insurance companies and their consumers, and puts a straightjacket on continued foreign insurer assistance to the US market."[11] Other opponents included the Risk and Insurance Management Society, the Florida Consumer Action Network, the National Risk Retention Association, the Organization for International Investment, the Association of Bermuda Insurers and Reinsurers, and the CEA (the European insurance and reinsurance federation). The groups formed the Coalition for Competitive Insurance Rates as the Senate Finance Committee commenced hearings last fall.[12]

Chairman Max Baucus (D-MT) released a discussion draft proposing to modify the tax treatment of insurance companies that deduct premiums in excess of the industry average.[13] The draft is virtually identical to the bill introduced by Rep. Neal. Chairman Baucus invited public comment to further understand the potential impact that changes may have for insurance companies as well as consumers to be submitted by no later than February 28, 2009.[14] A Senate Finance Committee staffer stated that its version differs from H.R. 6969 by taking into account offshore income already subject to US tax.[15]

10 US Congressional Record, September 18, 2008.
11 Association of Bermuda Insurers and Reinsurers; Organization for International Investment, *Isolationist US Insurance Tax Bill (HR 6969) Would Increase Insurance Prices for U.S. Consumers; Imposes Straightjacket on Insurers Needing Capital*, TAX NOTES TODAY, 2008 TNT 184-48, September 19, 2008.
12 R.J. Lehmann, *House Bill Would Cap Deductions for Offshore Reinsurance*, A.M. BEST COMPANY, Inc., September 22, 2008.
13 News Release, Committee on Finance, U.S. Senate, Senate Finance Committee Staff Discussion Draft of Proposal to Modify Tax Treatment of Insurance Companies that Deduct Premiums in Excess of the Industry Average (December 10 2008).
14 *Id.*
15 Martin Vaughan, *Senate Panel Proposal Targets Offshore Reinsurers*, DOW JONES NEWSWIRES, December 10, 2008.

House Ways and Means Chairman Rangel plans new tax reform effort

House Ways and Means Chairman Charles Rangel late in 2008 announced plans to introduce during the new 111th Congress a revised version of his "Tax Reduction and Reform Act of 2007," which proposed to offset the cost of reducing the corporate tax rate to 30.5 percent by enacting a range of revenue-raising provisions. His earlier bill (H.R. 3970) included a number of significant proposals, including provisions to limit significantly the use of foreign tax credits, repeal worldwide interest allocation, limit certain tax treaty benefits, and codify the economic substance doctrine. Chairman Rangel also stated that the new bill he plans to introduce in 2009 would seek to reduce the corporate tax rate to 28 percent, which likely would require additional revenue raisers beyond those included in his earlier bill.[16]

MADE in the USA Tax Act

Senator George Voinovich (R-OH) introduced the Manufacturing, Assembling, Development, and Export (MADE) in the USA Tax Act (S. 3162), which promised to cut the domestic corporate rate from 35 percent to 28 percent and eliminate several international tax breaks.

Although S. 3162 had no specific provision amending or creating reinsurance legislation, it called on Congress to address the tax treatment of reinsurance transactions with related persons and other similar transactions, including the transfer offshore by reinsurance or otherwise of assets and earnings related to insurance of US risks. The bill asked Congress to consider the effects of such practices on the tax base of the United States, as well as the competitiveness of insurers and reinsurers based in the United States.

The bill would also amend Section 197(a) and (e) from a period of 15 years to 20 years and codify the economic substance doctrine.

Economic substance doctrine legislation analyzed

In a report dated March 24, 2008, the Congressional Research Service noted that many legislative proposals addressing the clarification of the economic substance doctrine sought to define "economic substance" without defining the doctrine.[17] There was concern that defining "economic substance" might provide "the seeds of the next tax shelter problem." With regard to cost saving and revenue raising, IRS Chief Counsel Donald L. Korb questioned whether the IRS would ever assert the strict liability penalty, pointing out that litigation would become more complex and that taxpayers would not have an incentive to cooperate with the IRS.[18]

16 Heather M. Rothman, *Congress: Rangel Says Health Care, Tax Reform To Dominate Ways and Means Agenda*, BNA DAILY TAX REPORT, November 21, 2008.

17 Carol Pettit, *The Economic Substance Doctrine: Legal Analysis of Proposed Legislation*, TAX NOTES TODAY, 2008 TNT 60-25, March 24, 2008.

18 *Id.*

The Voinovich legislation also included a number of international provisions promising to eliminate "tax incentives to move jobs and profits overseas," some of which involved:

- Include all foreign-source royalties in passive income category in applying the foreign tax credit limitation
- Apply the foreign tax credit limitation separately to financial services income
- Treat certain foreign corporations "managed and controlled" in the United States as domestic corporations
- Treat certain entities created and organized under the laws of any country and that have a single owner as corporations
- Include an anti-treaty shopping provision
- Modify the limitation on excess interest deductions of certain corporations
- Shut down abusive nonqualified deferred compensation arrangements

In 2009, Congress may consider significant business tax proposals as part of a general debate over tax reform and the expiration of the 2001 and 2003 Acts. As a Republican favoring the elimination of certain business tax provisions, Senator Voinovich's support for specific proposals could receive significant consideration by the Senate Democratic Majority Leadership.

Proposed Insurance Information Act of 2008

Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee Chairman Paul Kanjorski (D-PA) and Ranking Member Deborah Pryce (R-OH) introduced the Insurance Information Act of 2008 (H.R 5840) to establish a new Office of Insurance Information (Office) within the Treasury Department.

In a press release dated April 18, 2008, Treasury Assistant Secretary for Financial Institutions, David G. Nason, welcomed Chairman Kanjorski and Ranking Member Pryce's introduction of this legislation, and noting its similarity to a proposal in the Treasury's Blueprint for a Modernized Regulatory Structure, expressed his belief that it would help the United States address international regulatory issues affecting our markets' competitiveness. Many large national firms backed the proposal, while small regional insurers resisted the extra layer of oversight that a new federal regulator would bring. In a statement regarding the Treasury's Blueprint for a Modernized Regulatory Structure, the National Association of Insurance Commissioners cautioned against federal intervention in a state-based system.[19]

19 Press Release, US Department of Treasury, Assistant Treasury of Secretary David G. Nason Remarks on Treasury's Blueprint for a Modernized Regulatory Structure (April 29, 2008).

If enacted, the legislation would establish the office, to be headed by a deputy assistant secretary appointed by the secretary of the Treasury, and which would receive, analyze, collect, and disseminate publicly available data and information and issue reports regarding all lines of insurance, except health insurance. In addition, the office would advise the Treasury secretary on major domestic and international policy issues, report to Congress every two years, and establish federal policy on international insurance matters. The office would also be charged with the duty of ensuring that state insurance laws remain consistent with federal policy in coordinating international trade agreements.

The bill provided that any law or regulation of any state would be preempted, to the extent that such law or regulation was inconsistent with federal policy on international insurance matters set forth in an agreement entered into by the United States or on its behalf by a designated representative. House Resolution 5840 would also establish an advisory group to help inform and advise the head of the office consisting of no more than nine members who would be appointed by the secretary. The advisory group would make recommendations to the secretary and the deputy assistant secretary and include representatives of the National Association of Insurance Commissioners, the Department of Commerce, and the Office of the United States Trade Representative, as well as representatives of the insurance industry, consumer groups, and other organizations as the secretary determined to be appropriate.

Senator Baucus calls for healthcare reform

Senate Finance Committee Chairman Max Baucus (D-MT) wrote a "Call to Action" outlining his vision for healthcare reform, focusing on the issues of healthcare coverage, quality, and cost. The whitepaper was posted on Chairman Baucus' Senate website.[20]

Economic and tax policy agenda[21]

The United States continues to face extraordinary fiscal and economic challenges from the continuing housing crisis, turmoil in financial markets, and the current economic recession. Recent economic indicators on GDP growth, job losses, and consumer anxiety suggest that the US economy will not rebound as quickly as thought just a few months ago. Indeed, the economic downturn appears to be deepening and spreading to more sectors.

As a result, action to accelerate economic recovery is the highest-priority issue in Washington. Congressional leaders are actively working on economic recovery legislation with the expectation that the legislation will be passed by the new Congress and sent to the new President by mid-February. During the election campaign, President Obama expressed support for a package of economic stimulus proposals, including individual tax relief, a business tax credit for new hires, increased small business expensing, increased infrastructure spending, and relief to states. These proposals are likely to be part of any economic recovery solution.

20 Baucus, Max, *Call To Action – Health Reform 2009* (November 12, 2009) http://finance.senate.gov/healthreform2009/finalwhitepaper.pdf.

21 Excerpt from, PricewaterhouseCoopers' *Tax policy in transition: 2009 tax legislative outlook, available at* http://www.pwc.com/extweb/pwcpublications.nsf/docid/3869CF1C05D1766785257537004E53E1/$file/2009_tax_legislative_outlook.pdf (last visited January 15, 2009).

Although economic recovery will be the primary focus of legislation in early 2009, President Obama also campaigned on major legislative initiatives such as middle-income tax relief, business tax changes, healthcare reform, climate change, and energy independence. The new administration is expected to include many of these domestic policy initiatives in its first budget submission to Congress, which will be released in February or March.

Congressional committee chairmen in both chambers will continue to exercise significant influence over the shaping of specific legislative proposals. For example, Senate Finance Committee Chairman Max Baucus (D-MT) already has staked out positions on economic recovery legislation and healthcare reform. House Ways and Means Committee Chairman Charles Rangel (D-NY) is preparing to reintroduce comprehensive tax reform legislation.

Federal budget considerations may act to control the scope of tax and spending legislation. The federal deficit for fiscal 2009 is expected to exceed $1 trillion. In addition, the United States faces near- and long-term budget challenges, such as the scheduled expiration of individual tax relief enacted in 2001 and 2003, the growing number of individual alternative minimum tax (AMT) taxpayers, rising concern about global business competitiveness, and the growing cost of entitlement spending programs (e.g., Social Security, Medicare, and Medicaid). There is a growing belief that these issues can be addressed on a permanent basis only in the context of fundamental tax reform.

While tax relief for individuals may drive tax reform, Congress also may consider business tax reforms to promote US investment and employment. The US economy today is more globally integrated than ever, both through exports and cross-border investment. The ability of US companies to grow and compete in the foreign markets that represent 95 percent of the world's consumers is essential to future US economic growth. There is growing concern that differences between the US tax system and the tax laws of the country's major trading partners adversely affect the international competitiveness of US businesses.

International business competition[22]

The desire of policymakers for an internationally competitive business tax system reflects the increasing integration of the United States in the global economy. Low-cost communications and transportation have expanded the ability of corporations to operate on a global scale, both through trade and cross-border investment. Over the past 40 years, US exports have doubled relative to the size of the economy, while the share of corporate profits earned abroad by US corporations has more than tripled.

At the same time, the United States, which once dominated the ranks of the leading international companies, now is one competitor among many. Worldwide, cross-border investment expanded from less than six percent of worldwide output in 1980 to 26 percent in 2006. In 1960, the United States accounted for more than half of outward cross-border investments; by 2006, it accounted for less than one-fifth. In 1960, the United States was home to 70 of the top 100 industrial corporations; now it is home to 38.

22 *Id.*

The question facing US policymakers is how tax policy should respond to the changing patterns of foreign investment since the early 1960s. Two key issues receiving attention are the US corporate tax rate and the tax rules applicable to foreign earnings of US companies.

Corporate tax rates. The US statutory corporate tax rate is much higher than the rates of most of its trading partners. The combined top federal, state, and local US corporate income tax rate is 39.3 percent—the federal rate of 35 percent plus an average state and local tax rate of 6.54 percent (4.3 percent after deduction against federal income tax). This is the second highest (after Japan) among the 30 members of the Organization for Economic Cooperation and Development (OECD) and 12.7 percentage points greater than the OECD averages.

US taxes on foreign income. For many US companies, another key issue for maintaining competitiveness abroad is the ability to defer US tax on active foreign earnings until this income is brought home. Approximately one-third of OECD countries provide for such worldwide taxation. The remaining two-thirds have "territorial" tax systems, under which active foreign earnings are not taxed at all by the home country. Enacting further limitations on the ability of US companies to defer US tax on foreign earnings could erode the competitiveness of US companies.

In light of the preceding factors, numerous tax reform proposals have attracted attention in recent years. Among these, a comprehensive tax reform bill introduced in October 2007 by Ways and Means Chairman Rangel is analyzed below; Treasury base-broadening options from December 2007 also are noted.

Chairman Rangel's tax reform legislation[23]

In October 2007, Ways and Means Chairman Rangel introduced a comprehensive tax reform bill (H.R. 3970, the Tax Reduction and Reform Act of 2007) that would repeal the individual AMT and reduce the corporate income tax rate from 35 percent to 30.5 percent. H.R. 3970 is revenue neutral, with revenue loss from individual AMT repeal fully offset by individual tax increases, and revenue loss from corporate rate reduction offset by business tax increases.

Three corporate revenue-raising provisions account for most of the offsets proposed to pay for rate reduction. These are proposals to repeal the domestic manufacturing deduction, repeal the "last-in, first-out" (LIFO) accounting method, and a measure to defer deductions allocable to foreign-source income and restrict the use of foreign tax credits. That last proposal has generated considerable concern within the business community.

23 *Id.*

This year, Chairman Rangel is expected to propose a revised version of his comprehensive tax reform bill. Among other changes, Chairman Rangel is expected to propose reducing the corporate income tax rate to 28 percent. If so, the bill could include other business tax increases, such as additional limitations on accelerated depreciation, to offset the additional revenue loss associated with the anticipated further reduction in the corporate tax rate.

For purposes of economic recovery legislation, Congressional "pay-as-you-go" budget rules—requiring any tax cuts to be completely offset with either tax increases or reductions in mandatory (entitlements) spending—are not expected to apply. However, as the economy begins to recover, there may be renewed focus on the need to control federal budget deficits. As a result, there likely will be pressure to consider business tax increases and other revenue-raising tax proposals to offset future tax legislation.

Healthcare reform[24]

President Obama has pledged to make universal healthcare coverage one of his administration's top priorities. The number of uninsured Americans continues to grow, as do healthcare costs, which are at 16 percent of GDP and rising.

In particular, President Obama has proposed implementation of a series of policies intended to provide coverage to individuals unable to purchase health insurance, while not significantly disrupting coverage for the 85 percent of Americans who have health insurance.

The President's proposals include tax subsidies for the 15 percent of Americans who are uninsured and for small businesses that cannot afford to offer health coverage to their workers. Regarding the latter, President Obama has proposed creating a new refundable 50-percent tax credit for employee health insurance premiums paid by small business employers. The President also has proposed creation of as-yet unspecified penalties for employers that do not provide coverage and for parents who do not obtain coverage for their children.

24 *Id.*

Previously proposed revenue-raising tax provisions

Provision	Source	10-year revenue estimate (millions)
International		
Tax the worldwide income of US corporations as it is earned	CBO	39,1000
Repeal worldwide interest-allocation rules	Rangel	26,214
Treat certain US-controlled foreign corporations (CFCs) located in “tax-haven” countries as domestic companies for US tax purposes	Other	5,800
Repeal deferral of US income tax on income earned by the foreign subsidiary of a US company that is attributable to sales in the United States	Other	4,200
Impose stricter limits on related-party interest deductions by expatriated entities	Treasury	1,655
Apply anticorporate inversion legislation retroactively	Senate	1,241
Modify entity classification rules to reduce opportunities for tax avoidance	JCT	1,200
Amend rules for determining corporate residency	JCT	900
Require reporting of payments to, and restrict tax benefits for, income flowing through identified tax havens	Clinton	200
Deny the preferential maximum 15 percent dividend tax rate for certain dividends from foreign corporations	Other	N/A
Tax accounting and corporate		
Reduce net operating loss carryback period to one year	Senate	20,000
Modify dividends received deduction	Rangel	4,600
Insurance		
Modify rules for capitalizing policy acquisition costs of insurance companies	Clinton	8,842
Require recapture of policyholder surplus accounts	Clinton	1,844
Increase the proration percentage for property and casualty insurance companies	Clinton	1,228
Disallow deduction for interest on debt allocable to tax-exempt income of insurance companies	JCT	1,200
Modify treatment of sales of life insurance contracts	Clinton	407
Disallow a deduction for “excess” reinsurance premiums paid to foreign affiliates	Other	N/A

03
Reserves

Introduction

The issue of dividends received deductions (DRDs) on separate accounts of life insurance companies and the calculation of reserves have provoked dissatisfaction, questions, comments, and proposals from industry participants and their advisors. During the year, the IRS weighed in on DRDs by issuing a directive on the examination of DRDs in separate accounts of life insurance companies and providing guidance on the computation of reserves. The IRS reinstated its stance on what constitutes a "change in basis" versus a "correction of error" and the treatment under Section 807. The IRS also provided the annual insurance rates for calculation of reserves, loss payment and salvage discount factors for the 2008 accident year, and comments on modernization proposals that may be helpful to the participants in the industry.

LIFE

Separate account dividends received deduction (DRD)[1]

The IRS Large and Midsize Business (LMSB) Division issued LMSB-04-0308-010, an industry directive that provides guidance to agents on the examination of the DRDs incurred in connection with separate accounts of life insurance companies.

Rev. Rul. 2007-54, released August 16, 2007, in part addressed the interest rate used under Section 812(b)(2) to calculate required interest on the reserves held in the separate account of life insurance companies. The ruling, however, was subsequently suspended. Taxpayers were informed that the issues considered in the ruling would be more appropriately addressed by regulations, a project added to the 2007–2008 Priority Guidance Plan, but not completed during the year.[2]

Although the IRS stated that the DRD on separate accounts of life insurance companies issue is not a mandatory examination item, it encourages agents to consider the issue in their risk analysis and to develop the issue if the risk analysis indicates it is material. However, the IRS strongly cautions agents against applying the suspended Rev. Rul. 2007-54.

In two attachments to the directive, the IRS provided guidelines for issuing an information document request (IDR). Of specific importance is a request in Attachment 1 of the IDR to identify the nature, amount, and statement location of any additional statutory variable contract reserves, a guaranteed minimum withdrawal benefit (GMWB), a guaranteed income benefit (GIB) or a combination of such benefits and the corresponding tax reserves that are held for each year under audit. Attachment 2 requests a listing of tax reserves by issue year showing the corresponding interest rates used under Section 807(d) for each issue year. According to the IRS, if the responses to the questions listed in Attachment 1 indicate that the applicable reserve method for variable life or variable annuity contracts is the reserve computed under Section 807(d)(2) and/or that required interest for separate accounts may need to be recomputed, agents may request an IDR for information listed in Attachment 2.

1 LMSB-04-0308-010.
2 Rev. Rul. 2007-61; 2007-42 I.R.B. 799.

Statutory reserves for multistate insurer defined[3]

In Rev. Rul. 2008-37, the IRS addressed the situation where a life insurance company does business in several states with different minimum reserve requirements. In these situations, the amount of the company's statutory reserves under Section 807(d)(6) is the highest aggregate reserve amount set forth on an annual statement pursuant to the minimum reserving requirements of any state in which the company does business.

For purposes of determining a life insurance company's income or deduction from decreases or increases in life insurance reserves, Section 807(d)(1) provides that the amount of the life insurance reserves for any contract is the greater of (1) the contract's net surrender value or (2) the contract's tax reserve determined under Section 807(d)(2). However, the life insurance reserves for a contract cannot exceed the amount that would be taken into account with respect to the contract in determining "statutory reserves," as defined in Section 807(d)(6). Accordingly, the statutory reserves with respect to a contract operate as a limit on the amount of the contract's life insurance reserves that might otherwise be taken into account in determining a life insurance company's taxable income. Statutory reserves do not include any reserve attributable to deferred and uncollected premium if the establishment of such reserve is not permitted under Section 811(c).

In the ruling, the IRS described two situations illustrating how the ruling would apply. Both examples involve an insurance company doing business in 45 states. The company was subject to regulation under the insurance laws of each state in which it did business, and each state had laws or regulations for determining the minimum amount of reserves the company was required to set aside to mature or liquidate policyholder or beneficiary claims.

In the first situation, the insurance company filed one annual statement in all states in which it conducted business. This statement reflected the highest minimum reserve required by any state in which the company conducted business. In the second situation, the company filed an annual statement with each state reflecting the minimum amount of reserves required by that state. Accordingly, more than one annual statement was filed by the second company.

In both situations, the amount of the company's end-of-year statutory reserves under Section 807(d)(6) was determined as the highest aggregate reserve amount for Section 807(c) items on the statement pursuant to the minimum reserve requirement of any state in which the company did business.

While this is the conclusion believed to be appropriate by most tax advisors and insurance companies, the IRS has taken a different view in certain examinations.

On its website, the IRS offered assistance to insurance companies on how to file returns in order to comply with minimum reserve requirements set forth in Rev. Rul. 2008-37, an initiative targeting companies filing a 2007 Form 1120-L on or after September 25, 2008.

3 Rev. Rul. 2008-37.

Generally, companies must ensure the IRS has a copy of any annual statement the company used as the basis for taxable income. Companies that do not file Form 1120-L electronically must attach a copy of the National Association of Insurance Commissioners (NAIC) annual statement filed with the state of domicile and used as the basis for computing taxable income. Companies that use a different annual statement as the basis for computing taxable income should attach that annual statement to Form 1120-L. According to the IRS, companies that do not file Schedule M-3 with the Form 1120-L must attach a schedule that reconciles Form 1120-L with the annual statement used as the basis for computing taxable income reported on Form 1120-L. If the annual statement used to prepare the tax return is different from the NAIC annual statement filed with the state of domicile, companies need to include a separate reconciliation of lines 1 through 6 of Schedule F to the annual statement filed with the state of domicile.

The IRS indicated that life insurance companies that already filed 2007 Form 1120-L are not required to file an amended tax return, but must provide the above information to the IRS upon request.

New proposed actuarial guidelines[4]

In Notice 2008-18, the IRS responded to concerns raised by insurance companies, industry groups, and advisors regarding two reserve methodology projects underway with the NAIC. Those methodology projects are:

- Proposed Actuarial Guideline VACARVM would set forth a new Actuarial Guideline that would constitute Commissioners Annuity Reserve Valuation Method (CARVM) for variable annuities.
- A proposed principles-based approach for calculating statutory reserves for life insurance (Proposed Life PBR) would take the form of a section of a proposed valuation manual that would be adopted pursuant to a proposed change to the standard valuation law.

These new reserve methodologies raise many questions on how reserves computed in accordance with these proposed requirements would affect the taxation of insurance companies. In notice 2008-18, the IRS identified areas in which the government has concerns, sets forth the manner in which the government may address the issues in the absence of future legislation, and invited comments on these and other issues. The Treasury and IRS indicated that they do not anticipate changes to existing guidance which requires that tax principles override statutory accounting principles in appropriate cases.[5]

While the government has raised many concerns, one overriding concern seems to be the ability of the examiners to audit the conditional tail expectation under VACARVM and the stochastic reserve under principles-based reserve (PBR). The government indicates that this may weigh in favor of recognizing only the standard scenario amount under CARVM and the deterministic reserve under PBR.

4 Notice 2008-18.

5 *See, e.g.,* Reg. Section 1.801-4(e) (as amended in 1972) (enumerating reserves and liabilities that do not qualify as life insurance reserves for federal income tax purposes).

The primary issues identified by the notice (which are described as "preliminary nonexclusive list") include life insurance qualification, life contract qualification under Section 7702, contract-by-contract versus aggregate reserves, the prevailing state-assumed interest rate, prevailing mortality tables, and the application of transition rules to contracts in force.

ACLI comments on Notice 2008-18[6]

William C. Elwell and Walter C. Welsh of the American Council of Life Insurers (ACLI) commented on guidance notifying life insurance companies of tax issues that could arise from adopting proposed methods for computing statutory reserves for variable annuity and life insurance contracts. Notice 2008-18 is valuable to the ACLI and the NAIC because it outlines issues and concerns that the Treasury and IRS have identified with the modernization proposals and as well as some potential solutions.

IRS reposts Section 807(f) coordinated settlement position

In February, the IRS reposted a 2001 coordinated issue settlement position guide on examinations of Section 807 adjustments to basis, which explains under what circumstances a change is a "change in basis" or a correction of error.[7] The paper states certain criteria for the treatment of reserve adjustments and comments that, in line with Rev. Rul. 94-74, inadvertent errors are limited to nonrecurring errors that affect the determination of a taxpayer's reserves only for a particular year. The IRS noted that some industry participants have asserted that the IRS takes too narrow a view of what constitutes an error in a reserve computation, while taking an overly broad view of what represents a change in basis. The IRS, however, did not change its position, which it stated was consistent with Rev. Rul. 94-74, and added:

> "The Service's position, nevertheless, is not free from litigating hazards. For example, given the substantial discussion that preceded publication of Rev. Rul. 94-74, 1994-2 C.B. 157, and the underlying coordinated issue paper, there may be hazards concerning the difference between an actuarial assumption and an error. Furthermore, potential disagreements could arise concerning CARVM and the calculation of tax reserves, possibly giving rise to litigation."

6 Letter from American Council of Life Insurers to Eric Solomon, Assistant Secretary for Tax Policy, US Treasury Department, and Donald L. Korb, Chief Counsel, May 9, 2008, TAX NOTES TODAY, 2008 TNT 94-21, May 9, 2008.

7 IRS, *Industry Specialization Program Coordinated Issue Settlement Position*, BNA DAILY TAX REPORT, February 19, 2008.

Assumption of annuity contracts[8]

In private letter ruling (PLR) 200820009, the IRS held that neither the assumption of insurance and annuity contracts nor related modifications would affect the contracts under specific code sections, would constitute a disqualifying distribution, or result in income to contract beneficiaries.

The relevant transaction arose in the context of a plan for the rehabilitation of Ceding Company (the plan) and involves the transfer by assumption of reinsurance of Ceding Company's life insurance and other contracts to Assuming Company under the supervision of the State A court. The plan indicated that each contract in force on the closing date of the reinsurance transaction would be modified by Ceding Company through one or more endorsements, effective as of the closing date but immediately prior to the closing of the reinsurance of the endorsed contracts. Certain "tax-qualified" contracts would be authorized to receive compensation for the extinguishment of mutual membership interests in the form of credits to the policy values (plan credits). Mutual members who held nontrusteed tax-qualified retirement funding contracts would not receive, or be entitled to receive, distributable equity with respect to such tax-qualified contracts. Instead, they would receive credits to the plan credits in the form of additional paid-up insurance or account-value credits. The value of the plan credits would equal the value of the cash otherwise allocable to the qualified contract holders with respect to their tax-qualified contracts. Assuming Company would receive assets from Ceding Company for purposes of paying the plan credit amounts.

In addition to examining PLR 200814005, the IRS relied upon Sections 72(e)(5), 401, 402, 403, 408, and 408A. The IRS stated that, based upon the taxpayer's representations, the transferred life insurance contracts, and annuity contracts qualified as such for federal tax purposes, neither the modification of a contract by endorsement, nor any amount paid or credited with respect to a contract pursuant to court approval, nor the assumption reinsurance of an endorsed contract pursuant to the plan without a change of terms or conditions would, in the case of a contract that is part of a qualified plan, have any effect on such contract for purposes of Sections 72(e)(5), 401, 402, 403, 408, or 408A.

The IRS concluded that the investment in the contract under Section 72 for each endorsed contract immediately after the assumption would remain the same as an unendorsed contract immediately prior to endorsement. The IRS also stated that neither the addition of a credit nor the right thereto constituted a distribution in violation of Sections 403(a), 402(b)(11), or 408(e). Further, the addition of a credit to a nontrusteed retirement funding account does not constitute a distribution nor a contribution and thus would not result in gross income to the employee or other beneficiary of such contract prior to actual receipt. This ruling supplements, but did not supersede the IRS's prior conclusions in PLR 200814005, which examined a transaction involving two life insurance companies where one of the company's contracts were transferred to the other by way of assumption reinsurance.

8 PLR 20082009.

Prevailing interest rates for computing reserves

In Rev. Rul. 2008-19, the IRS provided applicable federal rates and prevailing state interest rates for insurance companies to use in computing certain reserves. This information is to be used by insurance companies in computing their reserves for (1) life insurance and supplementary total and permanent disability benefits, (2) individual annuities and pure endowments, and (3) group annuities and pure endowments. The ruling supplements four schedules—Schedules A, B, C, and D—under Part III of Rev. Rul. 92-19 by providing prevailing state-assumed interest rates for certain insurance products issued in 2007 and 2008. The ruling also supplements Part IV of Rev. Rul. 92-19 by providing the applicable federal rates for computing reserves for 2007 and 2008.

Property and casualty

Loss discount factors[9]

The IRS released Rev. Proc. 2008-70 and Rev. Proc. 2008-71 prescribing the loss payment patterns/discount factors and the salvage discount factors, respectively, for the 2008 accident year.

These factors are used in computing discounted unpaid losses and estimated salvage recoverable under Sections 846 and 832, respectively. The 2008 discount factors were determined using the applicable interest rate of 4.06 percent.

Taxpayers should note that Rev. Proc. 2008-70 also corrects the composite discount factors used in the 2006 and 2007 accident years for taxpayers who used the composite method of Notice 88-100, used for computing discounted unpaid losses not separately reported on the annual statement.

9 Rev. Proc. 2008-70 and Rev. Proc. 2008-71.

04

Captives

Introduction

The IRS withdrew a portion of proposed Reg. Section 1.1502-13(e)(2)(ii)(C)[1] relating to the treatment of transactions involving the provision of insurance between members of a consolidated group. Under the proposed regulation originally published September 28, 2007, certain intercompany insurance transactions have been taken into account on a single-entity basis.

The IRS withdrew the proposed regulations in response to numerous comment letters received by the industry, which quickly joined forces in opposing the proposed regulatory changes.[2] Together, the Captive Insurance Companies Association and the Vermont Captive Insurance Association created the Coalition for Fairness to Captive Insurers (CFCI).[3] Along with CFCI, the following captive groups approached Congress and/or wrote comment letters invited by the IRS to oppose the proposed regulations: the Self-Insurance Institute of America (SIIA), the Captive Insurance Council of the District of Columbia (CIC-DC), the South Carolina Captive Insurance Association, Inc. (SCCIA), and the Montana Captive Insurance Association, Inc. (MCIA).[4] The IRS has stated that it will "continue to study whether revisions to the rules for intercompany transactions are necessary to clearly reflect the taxable income of consolidated groups."[5]

In 2005, the IRS sought comments regarding the use of segregated accounts or protective cell arrangements as alternative risk transfer vehicles, including recently in the healthcare sector.[6] In response, the IRS issued Rev. Rul. 2008-8 and Notice 2008-19 to provide guidance on when amounts paid to a cell of a protected cell company (PCC) are tax deductible under Section 162 as insurance premiums. The IRS also addressed risk shifting among partners and whether the insurance of a manufacturer's warranty constituted insurance.

Final regulations issued

On December 31, 2008, the IRS issued final regulations under Reg. Sec. 1.1502-13(e) relating to the treatment of transactions involving obligations between members of a consolidated group.[7] Although the final regulations adopt, with revisions, the proposed amendments to Reg. Sec. 1.1502-13(g) issued in September 2007[8], the final regulations do not include the previous provisions relating to insurance between members of a consolidated group.

1 Ann. 2008-25.
2 *Id.*
3 Caroline McDonald, Captive Groups Battle IRS Reg on Capitol Hill, NATIONAL UNDERWRITER PROPERTY AND CASUALTY, November 16, 2007.
4 *Id.*
5 Ann. 2008-25.
6 Barry Senterfitt, *Captive Insurance Arrangements More Common*, MANAGER HEALTHCARE EXECUTIVE, May 1, 2008.
7 T.D. 9442.
8 72 FR 55139.

Protected cell company arrangements[9]

The IRS issued Rev. Rul. 2008-8 to provide guidance for protected cell company arrangements.

Generally, a protected cell company (PCC) is a legal entity that has established multiple accounts, or cells, each of which has its own name and is identified with a specific participant, but is not treated as a distinct legal entity. With respect to contracts to which it is a party, each cell is funded by its participants' capital contributions and premiums collected, and is required to pay out related claims. The income, expense, assets, liabilities, and capital of each cell are accounted for separately from any other cell and from the PCC generally. The assets of each cell are statutorily protected both from the creditors of any other cell and from those of the PCC, unless the other cell or PCC has a direct creditor claim against the cell from whom enforcement is sought.

Section 162(a) provides, in part, that all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business shall be allowed as a deduction. Reg. Section 1.162-1(a) provides, in part, that among the items included in business expenses are insurance premiums against fire, storms, theft, accident, or other similar losses in the case of a business. To be eligible for these insurance premium deductions, a company must satisfy the requisites of an insurance company under Sections 816(a) and 831(c). In addition, the US Supreme Court has explained that for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present.

Under the new IRS guidance, a corporation may be classified as an insurance company within the meaning of Sections 816(a) or 831(c) if, based on all the facts and circumstances, the corporation conducts the arrangements and other activities of the cell.

In Rev. Rul. 2008-8, the IRS describes the following two situations in which the new guidance applies:

Situation 1

Each year, Corporation X, a domestic corporation that owns all the preferred stock issued with respect to Cell X, enters into a one-year contract whereby Cell X "insures" the professional liability risks of Corporation X, either directly or as a reinsurer of those risks. The amounts Corporation X pays as "premiums" under the annual arrangement are established according to customary industry rating formulas. In all respects, Corporation X and Cell X conduct themselves consistently with the standards applicable to an insurance arrangement between unrelated parties. Cell X does not enter into any arrangements with entities other than Corporation X. Cell X is adequately capitalized relative to the risks assumed under that arrangement.

9 Rev. Rul. 2008-8.

Situation 2

Corporation Y, a domestic corporation, owns all the preferred stock issued with respect to Cell Y, as well as all of the stock of 12 domestic subsidiaries that provide professional services. Together, the 12 subsidiaries have a significant volume of independent, homogeneous risks. Each year, each subsidiary of Corporation Y enters into a one-year contract with Cell Y whereby Cell Y "insures" the professional liability risks of that subsidiary, either directly or as a reinsurer of those risks. The amounts charged by each subsidiary as "premiums" under the annual arrangements are established according to customary industry rating formulas. None of the subsidiaries have liability coverage for less than 5 percent or more than 15 percent of the total risk insured by Cell Y. Cell Y retains the risk that it insures from the subsidiaries. In all respects, Corporation Y, Cell Y, and each subsidiary, conduct themselves consistently with the standards applicable to an insurance arrangement between unrelated parties. Cell Y does not enter into any arrangements with entities other than Corporation Y or its subsidiaries. Taking into account the total assets of Cell Y, both from capital contributions from Corporation Y and from amounts received pursuant to the arrangements the subsidiaries of Corporation Y, Cell Y is adequately capitalized relative to the risks assumed under those arrangements.

According to the IRS, the arrangement between Corporation X and Cell X is akin to an arrangement between a parent and its wholly owned subsidiary, which, in the absence of any unrelated risk, lacks the requisite risk shifting and risk distribution to constitute insurance. The arrangement between Corporation X and Cell X is not an insurance contract for federal income tax purposes. Therefore, Corporation X may not rely upon Section 162 to deduct as insurance premiums the amounts paid pursuant to the arrangement with Cell X.

Under the arrangements between the 12 subsidiaries of Corporation Y and Cell Y, the IRS found that the subsidiaries shift their professional liability risks to Cell Y in exchange for premiums in arrangements that are determined to be at arms length. The premiums are pooled such that a loss by one subsidiary is not in substantial part paid from its own premiums. In all respects, the subsidiaries of Corporation Y and Cell Y conduct themselves as if they were unrelated parties in a traditional insurance relationship. If the subsidiaries of Corporation Y had entered into identical arrangements with a sibling corporation that was regulated as an insurance company, the arrangements would constitute insurance, and amounts paid pursuant to the arrangements would be deductible as insurance premiums under Section 162. Accordingly, the arrangements between Cell Y and each subsidiary of Corporation Y were insurance contracts for federal income tax purposes, and the amounts paid pursuant to those arrangements were insurance premiums deductible under Section 162 if all other requirements for the deduction were satisfied.

It is important to note that in Corporation Y's case, neither Corporation Y nor any subsidiary of Corporation Y guaranteed Cell Y's performance, and all funds and business records of Corporation Y, Cell Y, and each subsidiary, were separately maintained. Further, Cell Y did not loan any funds to Corporation Y or to any other subsidiary, nor did it enter into any arrangements with entities other than Corporation Y or its subsidiaries.

For additional guidance beyond the holding of Rev. Rul. 2008-8, which is effective 12 months from publication or on February 4, 2009, the IRS directs taxpayers to Notice 2008-19.

Clarifying guidance for PCCs[10]

In Notice 2008-19, the IRS sets forth proposed guidance to address issues that arise if certain arrangements involving PCCs constitute insurance, including the status of such a cell as an insurance company within the meaning of Sections 816(a) and 831(c), and some of the consequences of a cell's status as an insurance company.

Specifically, under the proposed guidance of Notice 2008-19, a PCC would be deemed as an insurance company separate from any other entity if both the following conditions exist:

- The assets and liabilities of the cell are segregated from the assets and liabilities of any other cell and from the assets and liabilities of the PCC such that no creditor of any other cell or of the PCC may look to the assets of the cell for the satisfaction of any liabilities, including insurance claims (except to the extent that any other cell or the PCC has a direct creditor claim against such cell).
- Based on all the facts and circumstances, the arrangements and other activities of the cell, if conducted by a corporation, would result in it being classified as an insurance company within the meaning of Sections 816(a) and 831(c).

The IRS requested comments on the following:

1. What transition rules may be appropriate or necessary for PCCs or cells of such companies, if a PCC is not currently following the proposed rules, or if a cell of such a company qualifies as an insurance company for some taxable years but not for others
2. What reporting, if any, would be necessary on the part of an individual cell to ensure that a PCC has the information needed to comply with the proposed rules
3. Whether different or special rules should apply with respect to foreign entities, including controlled foreign corporations
4. Whether further guidance would be needed concerning the proper treatment of PCCs and their cells under the rules regarding consolidated returns
5. What guidance, if any, would be appropriate concerning similar segregated arrangements that do not involve insurance

The proposed guidance would be effective for the first taxable year beginning more than 12 months after the date the guidance is published in final form.

10 Notice 2008-19.

Risk shifting among partners[11]

In TAM 200816029, the IRS considered whether the general partner or the limited partnership should be deemed the insured entity under a purported insurance arrangement for the purpose of evaluating whether sufficient risk distribution existed among the entities to treat the arrangement as insurance for federal income tax purposes. In this evaluation, Parent (P) was the common parent of a group of affiliated entities classified as corporations, partnerships, and disregarded entities. Some of these covered entities were organized as limited partnerships under local law and classified as partnerships for federal income tax purposes. The ultimate general partner was a corporation indirectly owned by P. At least one of the entities involved was a limited liability company with more than one member. Among the entities was Corporation IC, a corporation intending to provide insurance coverage arising from workers' compensation, automobile liability, and general liability for some or all of the other member entities.

In addition to highlighting the requirement that there be both risk shifting and risk distribution under *Helvering v. Le Gierse*, 312 US 531 (1941), and that the risk must contemplate the fortuitous occurrence of a stated contingency under *Commissioner v. Treganowan*, 183 F.2d 288, 290-91 (2d Cir. 1950), the ruling also emphasized that the loss must be an economic insurance loss versus an investment risk. Moreover, in determining whether there were sufficient insureds (e.g., the 12 insureds set forth in Rev. Rul. 2002-90 and Rev. Rul. 2005-40), the IRS considered whether an organization was an entity separate from its owners or was disregarded for federal income tax purposes.

The IRS held that if an entity is classified as a partnership for federal income tax purposes and is of the type that has a general partner(s), then it is the general partner(s) whose risk of loss is shifted under the insurance contract because the general partner(s) is ultimately liable for liabilities exceeding partnership assets. Hence it is the general partner(s) who should be considered the insured under liability coverage for purposes of evaluating whether an arrangement constitutes insurance for federal income tax purposes. The IRS included a caveat where local law subjected the limited partner(s) to the same liability as the general partner(s). The IRS also determined that where liability does not attach to anyone other than the entity under applicable law (i.e., the entity has no general partners), the entity itself should be considered the insured under liability coverage for the purpose of evaluating whether an arrangement constitutes insurance for federal income tax purposes.

The IRS's analysis and conclusions disregard the fact that it is the assets of the limited partnership that are protected under the liability insurance arrangement. The fact that liability in excess of partnership assets rests with the general partner(s) implies that there are actually two insureds, the limited partnership and the general partner.

11 TAM 200816029.

Manufacturer's warranty not considered insurance[12]

In TAM 200827006, the IRS determined that a multiline retailer's purchase of warranty reimbursement insurance policies from a related captive insurance subsidiary (which is designed to reimburse the retailer's losses under its manufacturer's warranty obligation offered to customers of the retailer) does not constitute insurable risks for federal tax purposes.

In this case, the taxpayer sold products subject to a manufacturer's warranty that were provided to the consumer as part of the original sales transaction (manufacturer-branded products). The taxpayer also sold taxpayer-branded products made by various manufacturers which were purchased by the taxpayer and to which the taxpayer assumed the "manufacturer's warranty" (taxpayer-branded products). For these products, the taxpayer agreed, in exchange for lower product costs, to repair and replace such products under the supply agreements. The warranty provided with the taxpayer-branded products indentified the taxpayer as the party responsible for services promised in warranty provided to the consumer. The product manufacturer agreed to pay the taxpayer for service calls in excess of a target level.

The taxpayer entered into reimbursement policies with a wholly owned captive insurance subsidiary domiciled in a foreign country that has elected to be taxed as a domestic corporation under Section 953(d) and is included in the consolidated annual tax return of the taxpayer. The policies reimburse the taxpayer for warranty expenses incurred in connection with its service obligations under the manufacturer's warranty agreements for the taxpayer-branded products.

As it did in TAM 200816029 described above, the IRS relied on a long history of case law defining the term "insurance," including *Helvering v. LeGierse*, *Allied Fidelity Corp. v. Commissioner*, and *Commissioner v. Treganowan*, to distinguish the meaning of the term "warranty" from the term "insurance" for federal tax purposes.

According to the IRS, although a warranty, service contract, and insurance policy have many of the same features, the distinguishing feature which sets a warranty apart from an insurance policy is that the manufacturer's warranty guarantees the integrity of a manufactured item. A warranty or service contract guarantees that a company's own product will perform adequately for a period of time. The IRS distinguished these arrangements from an insurance contract that reimburses a loss caused by an outside force at work—such as a fire or accident. The IRS stated that when something goes wrong with a manufactured product, the loss is attributable to actions, or lack of actions, of the manufacturer. In other words, the IRS viewed the taxpayer as contractually stepping into the shoes of the manufacturer when it sold its branded products.

12 TAM 200827006.

The IRS distinguished a manufacturer's warranty from a separately priced extended warranty (which has been found to be "insurance" in a number of rulings issued by the IRS) by noting that an extended warranty protects the customer against failures occurring beyond the general merchantability period of the goods.

Finally, the IRS concluded that any risk that the taxpayer will pay out more in repairs than the amount factored into the price of the product for repair cost is a business risk, and that the insertion of a third party does not create insurance for federal tax purposes. As such, the manufacturer's original product warranty risks covered by reimbursement policies that were purchased by the taxpayer do not constitute insurable risks for federal tax purposes.

As it has done in the past, the IRS reiterated that there must be both risk shifting and risk distribution in order to constitute insurance. In this particular case, the IRS distinguished a warranty obligation from an insurance contract, labeling the former as a business risk that does not equate to an insurance risk.

05

Reorganizations

Introduction

The failure of 25 banks in 2008 spurred an acquisition frenzy.[1] JPMorgan Chase bought Bear Stearns and Washington Mutual, Bank of America bought Merrill Lynch, Wells Fargo bought Wachovia[2], and PNC Financial Services bought National City Corp., to name just a few.[3] To help banks and insurance companies in the financial services sector deal with the difficult issues facing them, the IRS provided two favorable rulings in the mergers and acquisitions (M&A) tax area. One ruling provided that an investment by the US government in a domestic company would not trigger an ownership change.[4] An earlier ruling permitted banks to utilize losses associated with bad debt reserves existing at a transaction date in an unlimited fashion.[5]

Significant controversy has surrounded the latter ruling, which is estimated to provide a windfall of $140 billion for banks, with many questioning the IRS's legal authority to issue the ruling.[6] Senator Chuck Grassley (R-IA) noted that while "Congress wants to help[,] we also have a responsibility to make sure power isn't abused and that the sensibilities of Main Street aren't left in the dust as Treasury works to inject remedies into the financial system."[7]

Some in the insurance industry have called for the expansion of these rulings to include nonbanks. Specifically, many financial guarantee insurance companies suffering very similar economic losses would like expansion of the rules to help make them more attractive to investors.

Although global merger and acquisition activities in the insurance sector were down 17 percent in 2008, for some insurance companies, 2009 could bring growth. While many insurance companies will be tending their wounds of 2008, others with strong balance sheets and access to capital could take advantage of the current economic environment and weaknesses of competitors by pursuing expansion opportunities.[8]

1 FDIC List of Bank Failures & Assistance, *available at* http://www.fdic.gov/bank/historical/bank/index.html.
2 Amit A. Paley, *A Quiet Windfall for U.S. Banks*, THE WASHINGTON POST, November 10, 2008.
3 Eric Dash and Andrew Ross Sorkin, *Government Seizes WaMu and Sells Some Assets*, NEW YORK TIMES, September 26, 2008; Dan Fitzpatrick, David Enrich & Damian Paletta, *PNC Buys National City in Bank Shakeout*, THE WALL STREET JOURNAL, October 25, 2008.
4 Notice 2008-100.
5 Notice 2008-83.
6 Amit A. Paley, *A Quiet Windfall for U.S. Banks*, THE WASHINGTON POST, November 10, 2008.
7 *Id.*
8 Iris Lai, *M&A Activity Expected to Rise in 2009 as Japan Emerges as Most Active Market*, BEST'S INSURANCE NEWS, January 6, 2009.

Demutualization

Policy holder[9]

In *Fisher v. United States*, the US Court of Federal Claims held that the open transaction doctrine applied to shares of an insurance company acquired as part of a demutualization, because cash received was treated as a return of capital.

In this case, Taxpayer purchased life insurance policies from Sun Life Assurance Company (Life), a mutual life insurance company. By virtue of the premiums paid, Taxpayer enjoyed the benefits of insurance, ownership, and voting rights in the company. Eight years later, Life undertook a plan to demutualize and become a wholly owned subsidiary of a holding company, Sun Life of Canada Holding Corp. (Holding). Shares of Life were exchanged for shares of Holding, with approximately 20 percent allocable to compensate for the loss of voting rights and 80 percent allocable to the loss of other ownership rights. Taxpayer opted for a cash election in exchange for the Life shares surrendered. At the same time, Taxpayer retained the existing life insurance policy. The gain on shares surrendered in exchange for cash was reported on the income tax return with no adjustment for any basis, and the resulting tax liability was paid. After being denied a claim for refund, Taxpayer filed suit.

The argument centered on the allocation of basis to the Holding shares. The IRS contended that the shares had zero basis. Taxpayer responded that basis could not be determined because the purchase price of the ownership rights could not be segregated from that of the life insurance policy to which the rights were tied. Reg. Section 1.61-6(a) provides that, in the case where a large asset is purchased and a component is then sold, the basis of the component is allocated based on fair market value. The presumption that fair market values are readily available can be ascertained from the assertion in the regulations that only in rare and extraordinary cases will property be considered to have no fair market value.

The court observed that the formula works only where fair market values of the component pieces can be derived. The court analyzed the regulatory history of the “open transaction doctrine” and cited a previous IRS ruling that held “when it is impractical or impossible to determine the cost or other basis of the portion of the property sold, the amount realized on such sales should be applied to reduce the basis of the entire property and only the excess over the basis of the entire property is recognized as gain.”[10]

9 *Fisher v. United States*, 82 Fed. Cl.780 (2008).
10 Rev. Rul. 77-414.

Fisher Observation

Government experts did not distinguish valueless property from property whose value is impossible or impractical to ascertain, the latter of which was the scenario in Fisher.[11] "The Court concluded that the ownership rights were "embedded values" that were not "monetized" until the demutualization occurred—a characterization which, in the court's view, rendered the rights to property with a value that was impossible or impractical to ascertain at the time they were first acquired, rather than, as the government's witnesses opined, property wholly bereft of value at that time."[12]

The court found that the facts and circumstances in Fisher were similar to other "open transaction doctrine" cases, and therefore this transaction was one of the "rare and extraordinary cases" where basis could not be determined; hence, the transaction remains open. Since the amount received by Taxpayer was less than the cost basis in the insurance policy as a whole, the amount received constituted a return of capital rather than the sale of the stock, and Taxpayer was therefore entitled to the refund requested.

The court noted that "some might see this case as a revivification of the "open transaction" doctrine....it is not...., it represents, rather, an unusual and unique result—one based on long-standing, though not often-invoked, legal principles, to be sure, but ultimately driven by relatively unique facts."[13] Since the statute of limitations for filing refunds is generally three years after the filing of the tax return, it will likely be too late for taxpayers relying on the Fisher ruling, unless overruled on appeal, to seek a refund for sales reported in the 2004 tax year or earlier, but may be available for later transactions or for taxpayers with open tax years.

Government appeals *Fisher*

On October 7, 2008, the government filed its appeals in the US Court of Appeals for the Federal Circuit.[14] Most industry experts expected the IRS to appeal, and, at this stage, the focus will likely be on valuation issues.

11 Robert Willens, *With 'Fisher' Ruling, Open Transaction Doctrine Lives*, BNA DAILY TAX REPORT, August 21, 2008.
12 *Id.*
13 *Fisher*, 82 Fed. Cl. at 799.
14 *Fisher v. United States*, 82 Fed. Cl. 780 (2008), appeal docketed, No. 2009-51 (Fed. Cir. October 7, 2008).

Ownership changes

IRS releases final regulations for Sections 846 and 197[15]

On January 22, 2008, the IRS issued final regulations—adopting the proposed regulations without substantive change—relating to an actual or deemed acquisition of an insurance company's assets under Section 338, which generally apply to:

- An actual or deemed acquisition of an insurance company's assets pursuant to an election under Section 338
- A sale or acquisition of an insurance trade or business subject to Section 1060
- An acquisition of insurance contracts through assumption reinsurance

Regulations under other sections were issued over the years and finalized in 2008 for the following items:

- Section 197 relating to the determination of adjusted basis of amortizable Section 197 intangibles with respect to insurance contracts
- Section 338 relating to increases in reserves after a deemed asset sale
- Sections 338 and 846 relating to the effect of a Section 338 election on a Section 846(e) election

The proposed regulations, which were released in March 2002 and revised in 2006, generally treat the deemed transfer of insurance or annuity contracts under Section 338 election provisions consistently with the treatment of assumption reinsurance transactions entered into in the ordinary course of business. In addition, the proposed regulations provide similar rules for acquisitions of insurance businesses governed by Section 1060, whether affected through assumption or indemnity reinsurance. While the 2006 regulations provided welcomed guidance on many of the tax intricacies of such transactions, practitioners took issue with some of the 2006 guidance and asked for further clarification on the several ambiguous issues.

The 2008 final regulations adopted the language of the 2006 temporary regulations, requiring the capitalization for reserve increases that clearly reflect a so called "bargain purchase."[16] The total amount of capitalization for increases in reserves for acquired contracts is limited to the fair market value of the old target's assets acquired in a deemed asset sale (other than Class VI and Class VII intangibles) over the adjusted grossed-up basis allocated to those assets. Furthermore, to the extent that the increases in reserves are attributable to specified insurance contracts, the new target must capitalize deferred acquisition costs under Section 848 with respect to the additional premium. The final regulations apply to acquisitions and dispositions of insurance contracts on or after April 10, 2006, although taxpayers may elect to apply this section to qualified stock purchases occurring prior to April 10, 2006.

15 T.D. 9377.

16 IRS, *Application of Section 338 to Insurance Companies; Correction,* TAX NOTES TODAY, 2008 TNT 15-21, March 17, 2008; see also T.D. 9377.

Regarding the determination of adjusted basis of amortizable Section 197 intangibles, under the final regulations, the amount of expenses capitalized under Section 848 as a result of an assumption reinsurance transaction equals the lesser of (1) the required capitalization amount for the transaction, or (2) the amount of general deductions allocable to the transaction. In the event that the acquirer purchases more than one category of specified insurance contracts, the determination of the amount capitalized under Section 848 is made as if each category were transferred in a separate assumption reinsurance transaction. An acquirer will determine its general deductions as if the entire amount paid or incurred for the acquired contracts were allocable to an amortizable Section 197 intangible. If the amount of required capitalization exceeds the general deductions limitation, then taxpayers may agree to forgo the general deductions limitation in making the determination.

A taxpayer that makes a Section 338 election may treat the new target as a new corporation, and that new corporation may adopt its own accounting methods without regard to the methods used by the old target. The 2008 final regulations also retain the rule that treats the new target and the old target as the same corporation for purposes of the Section 846(e) election. As a result, the new target may use the old target's historical loss payment pattern for purposes of discounting reserves, unless it revokes the election made by the old target and defaults to industry-wide factors prescribed by the IRS. The final regulations apply to acquisitions and dispositions of insurance contracts on or after April 10, 2006. Taxpayers may elect, however, to apply the regulations to qualified stock purchases occurring prior to April 10, 2006. While taxpayers are grateful for the much-anticipated guidance, some ambiguities remain.

Capital contributions not subject to anti-stuffing[17]

In Notice 2008-78, the IRS provided favorable tax treatment for corporations that incurred an ownership change subject to Section 382. Notice 2008-78 indicates that the IRS plans to issue regulations allowing far more flexibility for taxpayers to make or receive capital contributions during the two-year period ending on an ownership change date. Prior to the release of Notice 2008-78, taxpayers were generally subject to the harsh "antistuffing" limitations of Section 382(l)(1), whereby any capital contributions received within the two-year period ending on an ownership change date were presumed to be part of a plan a principal purpose of which is to avoid or increase the Section 382 limitation.[18]

17 Notice 2008-78.

18 PLR 200730003 provides that capital contributions received within a two-year period of an ownership change date to maintain minimum regulatory capital requirements of a US life reinsurance company did reduce equity value for purposes of calculating that annual Section 382 ownership limitation.

Notice 2008-78 provides that, notwithstanding Section 382(l)(1)(B), a capital contribution will not be presumed to be part of a plan a principal purpose of which is to avoid or increase a Section 382 limitation exclusively as a result of occurring during the two-year period ending on an ownership change date. Whether a capital contribution is part of a plan will be based on all facts and circumstances; however, Notice 2008-78 contains four safe harbor provisions whereby a capital contribution will not be considered part of a plan if it satisfies any of the four safe harbors. A capital contribution will generally not be considered part of a plan if:

1. The contribution is made by a person who is neither a controlling shareholder (determined immediately before the contribution) nor a related party; no more than 20 percent of the total value of the loss to corporation's outstanding stock is issued in connection with the contribution; there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change; and the ownership change occurs more than six months after the contribution.
2. The contribution is made by a related party, but no more than 10 percent of the total value of the loss corporation's stock is issued in connection with the contribution, or the contribution is made by a person other than a related party; and in either case there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change, and the ownership change occurs more than one year after the contribution.
3. The contribution is made in exchange for stock issued in connection with the performance of services or stock acquired by a retirement plan under the terms and conditions of Reg. Section 1.355-7(d)(8) or (9), respectively.
4. The contribution is received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built-in loss) or it is received before the first year from which there is a carryforward of a net operating loss, capital loss, excess credit, or excess foreign taxes (or in which a net unrealized built-in loss arose).

Taxpayers may rely on the rules described in Notice 2008-78 for purposes of determining whether a capital contribution is part of a plan for ownership changes that occur in any taxable year ending on or after September 26, 2008. For calendar year taxpayers, this notice will be effective for the tax year ended December 31, 2008. These rules will continue to apply until additional guidance is published.

No built-in loss for bank ownership changes[19]

In Notice 2008-83, the IRS provided guidance on the treatment under Section 382(h) of certain items of deduction or loss allowed after an ownership change to a corporation that is a bank (as defined in Section 581) both immediately before and after the change date (as defined in Section 382(j)). Notice 2008-83 provides, on a temporary basis, that a bank that recognizes a loss from the disposition of a loan or takes a bad debt deduction under the specific charge-off or reserve methods of accounting after a change in ownership will not be treated as a built-in loss or a deduction that is attributable to periods before the change date. Banks may rely on Notice 2008-83 unless and until additional guidance is issued.

Losses acquired by Treasury under Capital Purchase Plan[20]

The IRS subsequently issued Notice 2008-100, providing that the Treasury's acquisition of stock in ailing financial institutions under the Capital Purchase Program (CPP) pursuant to the Emergency Economic Stabilization Act of 2008[21] will not cause an ownership change under Section 382. Except as otherwise provided, such shares are considered outstanding for purposes of determining the percentage of loss-corporation stock owned by other 5 percent shareholders on a testing date. For purposes of measuring shifts in ownership by any 5 percent shareholder on any testing date occurring on or after the date on which the loss corporation redeems shares of its stock held by Treasury that were acquired pursuant to the CPP, the shares so redeemed shall be treated as if they had never been outstanding.

The IRS also provided special rules for preferred stock, warrants, options, and capital contributions. For federal income tax purposes, any preferred stock of a loss corporation acquired by Treasury pursuant to the CPP is treated as stock described in Section 1504(a)(4). Any warrant to purchase stock of a loss corporation that is acquired by Treasury pursuant to the CPP is treated as an option (and not as stock). For purposes of Reg. Section 1.382-4(d), any option held by Treasury that is acquired pursuant to the CPP will not be deemed exercised under Reg. Section 1.382-4(d)(2). For purposes of Section 382(l)(1), any capital contribution made by Treasury to a loss corporation pursuant to the CPP is not considered to have been made as part of a plan a principal purpose of which was to avoid or increase any Section 382 limitation. The IRS intends to issue regulations that set forth the rules described in Notice 2008-100. Taxpayers may rely on the notice until additional guidance is issued.

Shortly after the issuance of the notice, House Ways and Means Committee member Lloyd Doggett (D-TX) introduced a bill that would impose a start date and end date on the relief provided by the notice.[22] Senator Bernard Sanders (I-VT) introduced a second bill that would invalidate the notice and extend the invalidation retroactively.[23]

19 Notice 2008-83.
20 Notice 2008-100.
21 P.L. 110-343.
22 H.R. 7300.
23 S. 3692.

No transfer for valuable consideration[24]

In PLR 200826009, the IRS has ruled that the sale or exchange of membership interests in a limited liability company (LLC) classified as a partnership, either by another LLC or third-party investors, will not result in a transfer for a valuable consideration under Section 101(a)(2), provided there is no termination of the partnership.

Under the facts, Company X, an LLC classified as a partnership for federal income tax purposes, was in the business of buying options on the real estate of homeowners. These purchases entitled Company X to a portion of the future appreciation, if any, of the homeowner's personal residence that accrued from the time the option was purchased until its exercise, when a home was sold, or when the homeowner died. To protect itself against the risk that the homeowner might die before significant appreciation accrued in the value of the residence, the LLC acquired a life insurance policy from a commercial insurer on each homeowner, naming the LLC as the beneficiary. Once the LLC was fully funded, its nonmanaging member intended to sell its membership interests to third-party investors for cash. The LLC agreement for Company X contained provisions with respect to restrictions on transferability designed to avoid a termination of Company X under Section 708(b)(1)(B).

Section 7702(a) provides that the term "life insurance contract" means any contract that is a life insurance contract under the applicable law, but only if such contract (1) meets the cash value accumulation test of Section 7702(b), or (2)(A) meets the guideline premium requirements of Section 7702(c), and (B) falls within the cash value corridor of Section 7702(d).

Section 101(a) provides that gross income does not include amounts received under a life insurance contract, whether in a single sum or otherwise, if such amounts are paid by reason of the insured's death. Section 101(a)(2) provides that in case of a transfer for a valuable consideration by assignment or otherwise, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid to the transferee. The term "transfer for a valuable consideration" is defined under Reg. Section 1.101-(b)(4) generally as any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy. Section 708(b)(1)(B) provides in part that for purposes of Section 708(a), a partnership shall be considered as terminated only if within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

The IRS concluded that if life insurance policies are "life insurance contracts" within the meaning of Section 7702(a), the sale or exchange of membership interests in the LLC, either by a nonmanaging member or by any investors, would not result in a transfer for "valuable consideration" under Section 101(a)(2), provided there is no termination of the partnership under Section 708(b)(1)(B). This ruling would apply only if the life insurance policies in question are "life insurance contracts" within the meaning of Section 7702(a).

24 PLR 200826009.

Privatization[25]

In PLR 200842038, the IRS held that a conversion transaction between a government and newly formed mutual insurance company should be treated as a Section 351 stock transaction.

Under the facts of the ruling, Government conducted the insurance business through various state agencies for several years. Part of that time, the insurance business was conducted through a division of Government (Unit). Government moved the insurance business from public to private ownership pursuant to the privatization legislation through the following transactions (the "Conversion Transaction"):

- Newco was organized as a private mutual insurance company and had no shares of capital stock outstanding. The IRS granted Newco a federal tax exemption under Section 501(c)(27)(B) regarding the provision of workers' compensation insurance. Government transferred the assets relating to the insurance business to Newco, which assumed liabilities. The total fair market value of the assets transferred to Newco by Unit exceeded the liabilities assumed. The aggregate fair market value of the assets transferred to Newco by Unit equaled or exceeded the aggregate adjusted bases of such assets immediately after the exchange. Government did not retain any rights in the property transferred to Newco.
- Neither Government nor Newco issued any stock or debt in conjunction with the conversion transaction. Newco was subject to repayment of assets as evidenced by a note—the only indebtedness that was part of the conversion transaction. Unit was in "control" of Newco within the meaning of Section 368(c). In the conversion transaction, Unit constructively received equity interests in Newco approximately equal to the fair market value of the property transferred to Newco. Further, Newco was not an investment company within the meaning of Section 351(e)(1) and Reg. Section 1.351-1(c)(1)(ii).

The IRS held that for federal income tax purposes, the conversion transaction would be treated as if (a) Government transferred the insurance business to Newco in exchange for all of the interests in Newco and the assumption by Newco of related liabilities (collectively, the exchange) and (b) Government transferred a portion of the interests to the policyholders. The interests deemed received by Government were treated as Section 351(a) stock. Government recognized realized gain up to the fair market value of the note under Section 351(a) and (b)(1). The control requirement immediately after the exchange was satisfied because Government had the right, in choosing the privatizing method, to retain the interests or designate other persons to receive the interests. No loss was recognized on the exchange under Section 351(b)(2).

25 PLR 200842038.

No income, gain, or loss was recognized by Newco as a result of the exchange under Section 1032(a). The basis of each asset of the insurance business received by Newco in the exchange equaled the basis of that asset in the hands of Government immediately before the exchange, increased by the amount of gain, if any, recognized on the exchange under Section 362(a). The holding period was carried over from when the assets were owned by Government under Section 1223(2). For Newco's first year as a taxable entity (year ending December 31, * * *), the deduction for losses incurred under Section 832(b)(5) are computed using discounted unpaid losses.

IRS issues final unified loss regulations[26]

On September 9, 2008, the IRS issued final regulations under Sections 358, 362(e)(2), and 1502, providing rules to determine the tax consequences of a member's transfer of loss shares of subsidiary stock. The final regulations also provide that Section 362(e)(2) generally does not apply to transactions between members of a consolidated group. In addition, the regulations conform or clarify various provisions of the consolidated return regulations, including those relating to adjustments to subsidiary stock basis. The final regulations generally adopt the rules of the proposed regulations published in January 2007[27]. However, Reg. Section 1.1502-13(e)(4), relating to the application of Section 362(e)(2) to certain intercompany transactions, and Reg. Section 1.1502-32(c)(1)(ii), relating to the treatment of items attributable to property transferred in an intercompany Section 362(e)(2) transaction, have been withdrawn.

The earlier proposed regulations introduced the unified loss rule, consisting of three principal rules that would apply when a member transferred a loss share of stock of a subsidiary:

- Basis redetermination rule (that would reallocate investment adjustments to address both noneconomic and duplicated stock loss)
- Basis reduction rule (that would address noneconomic stock loss)
- Attribute reduction rule (that would address duplicated loss).

The final unified loss rule includes certain modifications in response to taxpayer concerns.

In December 2007, the IRS announced that the final unified loss rule applies to transfers on or after September 17, 2008, unless the transfer is made pursuant to a binding agreement between unrelated parties that was in effect before that date and at all times thereafter.[28] The final unified loss rule does not include an election to apply its provisions retroactively. In general, transfers of loss shares of subsidiary stock on or after September 17, 2008 will be subject to the unified loss rule and not Reg. Sections 1.337(d)-1, 1.337(d)-2, 1.1502-20, or 1.1502-35.

26 T.D. 9424.
27 72 FR 2964.
28 Notice 2008-09.

06
International

Introduction

A key element in international cooperation is the exchange of information. Information requests from foreign governments have been much more specific and are of a higher quality than what we have seen in prior years due to the number of bilateral agreements between foreign governments. The Organisation of Economic Co-operation helped facilitate a number of such agreements last year.

The IRS prescribed new insurance excise tax guidance, resulting in claims from many who felt that the IRS had overstepped their authority, and said so in comment letters. Likewise, the IRS instituted a compliance initiative for taxpayers that may have failed to pay or withhold excise taxes due under Section 4371, or who improperly claimed a waiver. Across the pond, a UK tribunal determined that an internet comparison of insurance services were not exempt from UK value added tax (VAT).

Organisation of Economic Co-operation and Development

Since 2000, the Organisation of Economic Co-operation and Development (OECD) countries have worked with global financial centers to improve transparency and accountability in cross-border transactions. "At a time when governments are seeking to forge a more stable world financial system, these are issues that need to be addressed with urgency," OECD Secretary-General Angel Gurría said.[1]

The OECD countries, the British Virgin Islands, and the Channel Islands joined to bring greater transparency to cross-border financial transactions as they signed 16 new bilateral agreements on the exchange of information for tax purposes, bringing the total number of such arrangements to 44 since 2000. The British Virgin Islands signed bilateral tax information exchange agreements (TIEAs) with Australia and the United Kingdom, and the Channel Islands each signed bilateral TIEAs with Denmark, the Faroe Islands, Finland, Greenland, Iceland, Norway, and Sweden. Progress is being made in other financial centers such as Cyprus and Malta, both of whom have removed the last impediments to a full exchange of information, and Belgium negotiated its first tax treaty with full exchange of information. Bahrain and the United Arab Emirates are implementing the OECD standards, and the government of Hong Kong (China) recently began reviewing its exchange of information policy.

IRS still watching for assets hidden offshore by US taxpayers

In light of the fact that foreign tax credits have nearly doubled from $47.6 billion to $89.3 billion between 2005 and 2007 and that foreign-source income has jumped 88 percent over the past three years, the IRS announced that it will continue searching for US taxpayers who may be hiding assets in offshore banks, noting that practitioners should watch for developments in competent authority and arbitration.[2]

1 OECD Secretary-General Angel Gurría, Interview, *New bilateral pacts enlarge network on exchange of information for tax purposes (October 30, 2008),(transcript available at OECD website)*

2 Allison Bennett, *Shott Says Investigations of U.S. Taxpayers Hiding Assets in Foreign Banks Not Over*, BNA DAILY TAX REPORT, October 29, 2008.

On July 17, 2008, the OECD Council approved the release of the final version of the Report on the Attribution of Profits to Permanent Establishments[3]. The report provides guidance on the principles for attributing profits to a permanent establishment under Article 7 of the OECD Model Tax Convention on Income and Capital. This final report replaces all previous drafts of the various parts, including the discussion draft of Part IV (Insurance Activities) published in August 2007. The report includes a preface and four parts. Part I sets out general considerations for attributing profits to permanent establishments, regardless of the business sector in which they operate. The latter three parts elaborate upon the application of this approach to permanent establishments of enterprises operating in the financial sector, where doing business in permanent establishment form is especially common. Part II describes the application of the approach to enterprises carrying on a banking business through a permanent establishment. Part III addresses the situation of permanent establishments of enterprises carrying on global trading in financial instruments. Finally, Part IV deals with the application of the approach to permanent establishments of enterprises carrying on insurance activities. This final report replaces all previous drafts of the various parts, including the interim version of Parts I through III published in December 2006 and the discussion draft of Part IV published in August 2007.

IRS releases fact sheet on tax gap and international taxpayers[4]

On March 18, 2008, the IRS released a fact sheet providing an overview of the taxation of worldwide income and noting that the agency will begin collecting certain data in an effort to improve voluntary compliance with the international tax provisions and close the perceived international tax gap. The fact sheet summarizes the filing requirements for foreign-source income, US source income of nonresident aliens and foreign corporations, and the use of Form 1099 (information return) or the foreign equivalent to report certain information. The fact sheet also notes how the IRS leverages over 60 bilateral tax treaties with other countries, and over 20 tax information exchange agreements (TIEAs) to receives information on foreign-source income and foreign transactions. Although the IRS acknowledged that there was no specific data to indicate what portion of the tax gap is attributable to international taxpayers, the IRS noted that in 2008 they will begin measuring payment, filing, and reporting compliance data of individual international taxpayers.

3 Organisation for Economic Co-operation and Development, *OECD releases final Report on the Attribution of Profits to Permanent Establishments (July 18, 2008), available at http://www.oecd.org/document/62/0,3343,en_2649_37989746_41027006_1_1_1_1,00.html* (last visited 1.14.2008).

4 *IRS Releases Fact Sheet on Tax Gap and International Taxpayers*, TAX NOTES TODAY, 2008 TNT 55-19, March 18, 2008.

Excise tax

Imposition of excise tax under treaty[5]

In Rev. Rul. 2008-15, the IRS clarified and amplified Rev. Rul. 58-612, 1958-2 C.B. 850, and described the insurance excise tax consequences under Section 4371 of insurance premiums paid by one foreign insurer to another (i.e., a foreign reinsurer). In particular, the ruling addressed the consequences of such payments where the foreign insurer is eligible for a waiver of the excise tax by income tax treaty, but the foreign reinsurer is not eligible. The ruling addressed both types of insurance excise tax waivers that may be provided by treaty.

Section 4371 imposes a federal excise tax (FET) on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer. Section 4371(1) imposes such excise tax at the rate of 4 cents on each dollar, or fractional part thereof, of the premium paid on the policy of casualty insurance or the indemnity bond, if issued to or for, or in the name of an insured as defined in Section 4372(d). Section 4371(2) imposes such excise tax at the rate of 1 cent on each dollar, or fractional part thereof, of the premium paid on the policy of life, sickness, or accident insurance, or annuity contract. Section 4371(3) imposes an excise tax at the rate of 1 cent on each dollar, or fractional part thereof, on reinsurance policies issued by a foreign reinsurer with respect to risks covered by contracts described in Section 4371(1).

Section 4372(a), for purposes of Section 4371, defines the term “foreign insurer or reinsurer” as an insurer or reinsurer who is a nonresident alien individual, a foreign partnership, or a foreign corporation. Section 4372(d)(1) defines the term “insured” to include a domestic corporation or partnership, or an individual resident of the United States, that is insured against, or with respect to, hazards, risks, losses, or liabilities wholly or partly within the United States. Section 4372(d)(2) defines the term “insured” to include also a foreign corporation, foreign partnership, or nonresident individual, engaged in a trade or business within the United States, that is insured against, or with respect to, hazards, risks, losses, or liabilities within the United States. Section 4372(f) defines the term “policy of reinsurance,” for the purposes of Section 4371(3), as any policy or other instrument by whatever name called whereby a contract of reinsurance is made, continued, or renewed against, or with respect to, any of the hazards, risks, losses, or liabilities covered by contracts taxable under paragraph (1) or (2) of Section 4371.

5 Rev. Rul. 2008-15.

Section 4373(1) provides an exemption whereby the tax imposed by Section 4371 shall not apply to any amount that is effectively connected with the conduct of a trade or business within the United States, unless such amount is exempt from the application of Section 882(a) pursuant to a treaty obligation of the United States. Section 4374 provides that any tax imposed by Section 4371 shall be paid, on the basis of a return, by any person who makes, signs, issues, or sells any of the documents and instruments subject to the tax, or for whose use or benefit the same are made, signed, issued, or sold.

Rev. Rul. 58-612 concluded that a policy of reinsurance issued by a foreign insurer covering any of the hazards, risks, losses, or liabilities covered by contracts taxable under Section 4371(1) and (2) is subject to the tax imposed on reinsurance policies by Section 4371(3), regardless of whether the primary insurer was a domestic or foreign insurer. Rev. Rul. 2008-15 also relies on *United States v. Northumberland Insurance Co., Ltd.*, 521 F. Supp. 70 (D. N.J. 1981), where the court held that the premiums ceded for a reinsurance policy issued by a foreign reinsurer are taxable if the underlying policy is issued to an "insured" as defined in Section 4372(d), and there is no requirement that the reinsured qualify as an "insured" to be subject to the excise tax.

The IRS concluded that the reinsurance excise tax imposed by Section 4371(3) on policies of reinsurance covering contracts described in paragraph (1), (2), or (3) of Section 4371 applies to reinsurance premiums paid by one foreign insurer or reinsurer to another foreign reinsurer, unless the second foreign reinsurer issuing the policies is itself entitled to an exemption from the excise tax under an income tax treaty with the United States.

Cascading theory

The IRS interpretation of Section 4371 as imposing the tax not only on the first such policy of insurance or reinsurance, but also on each such subsequent reinsurance policy, is known as the cascading theory.[6]

In Rev. Rul. 2008-15, the IRS clearly announced its position that the excise tax is imposed on every insurance or reinsurance transaction involving US risk, even those involving two foreign parties who presumably may not have nexus to the United States. It is unclear how the IRS will enforce these rules. It is possible that the IRS would seek information from the US insured, US broker, or US insurance company, or attempt imposing a tax obligation on the US party as a withholding agent.

6 *See* TAM 9621001.

Opposition to Rev. Rul. 2008-15[7]

A memorandum, submitted on behalf of seven insurance trade associations, questioned the basis for Rev. Rul. 2008-15, which imposes the insurance excise tax upon extraterritorial reinsurance transactions on the theory that the tax is a cascading tax. According to the memorandum, the ruling taxes first the US-to-foreign insurance transaction, and then imposes the tax on a second, independent reinsurance transaction, so that the tax is collected twice. In the industry's view, the ruling is based upon an erroneous construction of the statute and a failure to understand industry operations. It is the industry's position that imposing the tax on the subsequent reinsurance transaction is inconsistent with Congressional intent, legislative history, and past Treasury positions, and should be withdrawn to conserve government and taxpayer resources.

The seven associations that joined together to request withdrawal are the Reinsurance Association of America (RAA), the American Council of Life Insurers (ACLI), the American Insurance Association (AIA), the Association of Bermuda Insurers and Reinsurers (ABIR), the Council of Insurance Agents & Brokers (CIAB), the National Association of Mutual Insurance Companies (NAMIC), and the Property Casualty Insurance Association of America (PCI).[8] These national trade associations for the life insurance and property and casualty insurance industries represent companies that collectively underwrite substantially all of the life insurance and property and casualty insurance and reinsurance written in the United States, as well as the nation's leading commercial insurance agencies and brokerage firms.[9] In addition, organizations like the General Insurance Association of Japan and the Comite Europeen des Assurances (CEA) have all written to oppose Rev. Rul. 2008-15.[10]

Shortly after the ruling was issued, the IRS released Announcement 2008-18, reflecting the IRS's intent to emphasize examining foreign insurance or reinsurance companies writing US risks and possibly other US participants who are directly or indirectly involved.

Voluntary compliance initiative for excise tax payments[11]

In Announcement 2008-18, the IRS announced the establishment of a compliance initiative intended to encourage certain taxpayers that may have failed to pay or withhold excise taxes due under Section 4371, or failed to disclose that it claimed a waiver from complying with the taxes pursuant to an income tax treaty.

Generally, if a taxpayer participates in this initiative in accordance with the terms specified in Announcement 2008-18, the IRS will not conduct examinations covering insurance excise tax liabilities arising under the situations set forth in Rev. Rul. 2008-15, noted above, or any similar fact pattern, to the extent that premiums are paid or received by the participating taxpayer during any quarterly tax period prior to October 1, 2008.

7 Brenda Viehe-Naess, *Insurance Trade Groups Seek Withdrawal of Guidance on Foreign Insurance Excise Tax*, TAX NOTES TODAY, 2008 TNT 142-16, July 9, 2008.

8 *Id.*

9 *Id.*

10 Katsuo Handa, *Japanese Insurance Group Opposes Guidance on Foreign Insurance Excise Tax*, TAX NOTES TODAY, 2008 TNT 191-11, September 16, 2008; Michaela Koller, *European Insurance Group Disagrees With Guidance on Application of Excise Tax on Foreign Reinsurers*, TAX NOTES TODAY, 2008 TNT 123-23, March 30, 2008.

11 Ann. 2008-18.

In the case of a nonparticipating taxpayer, the IRS may (1) conduct examinations of the taxpayer covering any and all excise taxes due under Section 4371 for any open tax periods, including tax periods beginning prior to October 1, 2008, and (2) determine and assess the correct excise taxes due under Section 4371, including interest, additions to tax, and, if applicable, penalties.

A foreign insurer or reinsurer, as defined in Section 4372(a), or any other foreign person liable for the tax imposed by Section 4371 (eligible foreign person), is eligible to participate if such person (1) has failed to file timely one or more Form 720 returns and (2) pays or remits any foreign insurance excise taxes due with respect to premiums paid or received during any quarterly tax period ending prior to October 1, 2008. An eligible foreign person also includes any foreign insurer or reinsurer that has failed to satisfy the treaty-based return disclosure requirements of Reg. Section 301.6114-1(c)(viii), with respect to claiming an exemption from foreign insurance excise tax under a US income tax treaty during any such period. Notwithstanding that a foreign insurer or reinsurer is an eligible foreign person, certain failures to file a Form 720 return and pay excise tax will not fall within the scope of the initiative. Accordingly, failures to file and pay that occur during any quarterly tax period ending prior to October 1, 2008 will not be protected.

Filing tip

Taxpayers participating in the voluntary compliance initiative must file Form 720 with the Cincinnati Service Center and must also notify the IRS of its election to participate by including the following notation in red print at the top of the Form 720: "Election to participate in FET [Federal Excise Tax] Voluntary Compliance Initiative pursuant to Announcement 2008-18."[12]

This initiative does not apply, however, to failures to pay excise taxes with respect to a situation where the foreign insurer or reinsurer entered into an excise tax closing agreement with the IRS and failed to pay excise taxes on premiums that do not qualify for the exemption because the foreign person has retroceded, in whole or in part, the premiums on US risk to a nontreaty country or to a party not entitled to the exemption under the treaty.

Directive on FET compliance initiative

On October 24, 2008, the IRS issued a Director's Directive providing guidance to examiners auditing taxpayers who participate in the voluntary compliance initiative established by Announcement 2008-18.[13] As described above, if a taxpayer participates in this initiative, the IRS will not conduct examinations covering insurance excise tax liabilities arising under the situations described in Rev. Rul. 2008-15 to the extent that premiums are paid or received by the participating taxpayer during any quarterly tax period prior to October 1, 2008.

12 *Id.*
13 Director's Directive on Announcement 2008-18, FET Compliance Initiative (October 24, 2008).

According to the directive, to receive the benefits described in the announcement for the quarterly tax period October 1, 2008 through December 31, 2008, a taxpayer must:

- Report on a Form 720 return and maintain records of any transactions of insurance or reinsurance attributable to an "insured" as defined under IRC 4372(d) or with respect to the life or hazards of a US citizen or resident (collectively referred to as a US insured) to which the taxpayer itself is directly a party.
- Pay the full amount of tax due, either with the filing of the Form 720 return or with deposits. Failure to make timely deposits will not preclude the taxpayer from receiving the benefits under Announcement 2008-18. However, interest and penalties for failure to make timely deposits will be assessed.

The directive indicates that a taxpayer's satisfaction of the terms described above and receipt of the benefits of Announcement 2008-18 does not precluded examiners from assessing FET, including interest and penalties, on premiums subject to tax under Rev. Rul. 2008-15 from October 1, 2008 onward. To determine the amount of FET due on Form 720 under Rev. Rul. 2008-15 for premiums paid during the quarterly tax period October 1, 2008 through December 31, 2008, a taxpayer may use the safe harbor formula provided. The taxpayer should bear in mind that the safe harbor formula is only one of the methods the IRS has determined to be acceptable for calculating FET on transactions covered under Rev. Rul. 2008-15 and that they are not limited to this method.

The directive includes an attachment providing examples of the transactions it covers, including nonresident agents, solicitors, and brokers who pay premiums with respect to covered transactions. The guidance encourages taxpayers to enter into closing agreements pursuant to Rev. Proc. 2003-78 that may provide protection to their policyholders.

Automatic penalties for late Forms 5471

Beginning January 1, 2009, the IRS will automatically assert appropriate penalties on late filed Forms 1120 with Forms 5471 attached, according to a notice posted to the IRS website on October 22, 2008. Form 5471 is required to be filed by insurance companies, among other filers, if they meet certain shareholding requirements in foreign corporations.

Section 6038(b)(1) provides for a monetary penalty of $10,000 for each Form 5471 that is filed after the due date of the income tax return (including extensions) or does not include the complete and accurate information described in Section 6038(a). The IRS encourages taxpayers to submit delinquent Forms 5471 prior to January 1, 2009.[14]

14 *Penalties for Late Forms 5471 Automatic in January*, BNA DAILY TAX REPORT, October 24, 2008.

Premiums to offshore pool subject to excise tax[15]

In ILM 200844011, the IRS concluded that Section 4371 applied to premiums paid by a foreign taxpayer to a domestic pool because the premiums were paid to a foreign insurer or reinsurer for insurance policies, indemnity bonds, annuity contracts, or reinsurance contracts.

Parent, a US company, was head of a US consolidated group of corporations. Parent and its subsidiaries bought insurance covering its US assets, workers' compensation, and US commercial liabilities, and obtained catastrophic insurance from unrelated insurance companies. Parent bought insurance from Taxpayer, a wholly owned subsidiary covering its small claims. Taxpayer was incorporated in Country X and filed an election under Section 953(d) to be treated as a domestic corporation. Taxpayer's gross receipts primarily consisted of insurance premiums received on policies issued to Parent and its subsidiaries. Taxpayer was a member of a pooling arrangement (Pool), and ceded insurance on any claims less than $100,000 to the Pool in accordance with a contract (Contract).

Each year, Taxpayer and other Pool Members (Members) entered into the Contract with a management company that set the terms and limitations of the insurance risks ceded and assumed by Members. Other Members were unrelated captive insurance companies operating separately from each other. Pool analyzed risks for all Members and set premium rates. No single Member could prevent Pool from acting on its determinations. The participants' committee, with the manager's concurrence, had authority to determine all matters relating to the overall operation of Pool. Each Member transferred its risk for all claims less than or equal to $100,000 to Pool and agreed to assume a percentage of the risk for those claims. Members paid reinsurance premiums to Pool, with each Member assuming an equal amount of risk from Pool by receiving reinsurance premiums equal in amount to premiums paid to Pool. Claims arising from policies written by Taxpayer ceded to Pool were submitted by Taxpayer to Pool for settlement. Pool approved claims upon review and provided a statement of amounts due to Taxpayer, and then billed Taxpayer for its participating percentage of the total claims submitted. In effect, Taxpayer was paid its claim for less than the portion of Pool it reinsured.

The IRS determined that Pool was a separate entity under Reg. Section 301.77011(a)(1) and that Pool was a corporation. The IRS applied Rev. Rul. 83-132, providing that a noncorporate business entity engaged in the business of issuing insurance contracts is an insurance company under Reg. Section 1.801-3(a)(1), and therefore determined Pool was treated as an insurance company.

The IRS next applied Reg. Section 301.7701-5, which generally provides that a business entity is domestic if it is created or organized as any type of entity in the United States, or under the law of the United States or any state, otherwise it is foreign. Accordingly, the IRS held that Pool was a foreign corporation and a foreign insurer or reinsurer. Since Taxpayer was a Country X insurance company that was treated as a domestic corporation for purposes of US income taxation, when Taxpayer entered into the policy reinsurance contract with Pool (deemed as a foreign corporation), the Section 4371 excise tax was applied to the premiums paid by Taxpayer.

15 ILM 200844011.

Observation

Taxpayers with reinsurance pooling arrangements may have taken positions that are not entirely consistent with the conclusions reached in this advice. Taxpayers should review their specific facts and circumstances toward assessing any impact these positions may have from a federal income and excise tax perspective.

Section 953(d)

Extension to elect[16]

In PLR 200809013, the IRS granted an insurance company an extension to make an election under Section 953(d) to be treated as a domestic corporation for US tax purposes. Taxpayer was incorporated under the laws of Country Y. Since its inception, Taxpayer had issued only medical malpractice policies insuring the employees of Company A. Taxpayer retained CPA 1 to prepare its Year 1 US income tax return, but for reasons unknown to Taxpayer, CPA 1 resigned three days before the return due date without completing Taxpayer's Year 1 US income tax return. Taxpayer immediately retained Accounting Firm to prepare its Year 1 US income tax return, including the Section 953(d) election statement. Taxpayer received a letter from an IRS revenue officer rejecting the Section 953(d) election because it was not filed on or before the due date of Year 1, including extensions.

Under Reg. Section 301.9100-1(c), the Commissioner has discretion to grant a taxpayer a reasonable extension of time to make a regulatory election. Reg. Section 301.9100-3(a) provides that requests for relief will be granted when the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith and the grant of relief will not prejudice the interests of the government. One example of good faith under Reg. Section 301.9100-3(b)(1)(v) includes a taxpayer's reasonable reliance on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make or advise the taxpayer to make the election.

Under Rev. Proc. 2003-47, to be effective for a taxable year, the election to be treated as a domestic corporation under Section 953(d) must be filed by the due date prescribed in Section 6072(b), including extensions, for the US income tax return that is due. The IRS applied the Rev. Proc. to fix the time in which to make the election under Section 953(d).

According to the IRS, based on the facts and information submitted, Taxpayer satisfied Reg. Section 301.9100-3(a) and was granted an extension of 60 days.

16 PLR 200809013.

Vaule Added Tax (VAT)

Insurance services not exempt from VAT[17]

In *Insurancewide.com Ltd. v. HM Revenue & Customs*, the UK VAT Tribunal ruled that none of the insurance intermediary services provided by an internet comparison website fell within the UK VAT exemption.

Insurancewide.com (Insurancewide) provided an online comparison website service, putting potential customers in touch with insurers via a "click-through" from its website to that of an insurer or insurance broker. It received commission from the insurers based on the number of contracts resulting from the introductions. Over the years, the services provided by Insurancewide changed as technology developed. In 2002, Insurancewide introduced a system known as the Insurancewide Wizard that automated the selection process by obtaining and recording essential information required by insurers and applying that information to guide each prospective customer through to the most appropriate insurer(s). In its earlier terms and conditions, Insurancewide stated that it was not acting as an agent or broker. However, it was later granted permission by the Financial Services Authority to act as an intermediary.

Notwithstanding the designation, the tribunal found that none of the services provided by Insurancewide fell within the VAT exemption because Insurancewide was not an insurance agent. Insurancewide specifically disclaimed being an agent on its website and was found not to have had a role in the contract negotiation. Accordingly, Insurancewide did not have the power to bind the insurance company, which the tribunal considered an indicator of an agency relationship.

The tribunal considered whether any of the services provided by Insurancewide qualified as the "services of an insurance intermediary" (under UK law) or insurance "related services" under European Union law, which would have made them exempt had Insurancewide been an insurance agent. The tribunal found that, in performing the non-Wizard services, Insurancewide's role was not that of a mediator between the parties to a contract of insurance. It found that Insurancewide was "nothing more than an introducer and its role…..[could not] be properly distinguished from that of an advertiser in that via its website it had no interaction with either party beyond making the one aware of the other and providing a means of one contacting the other."[18]

Lloyd's Chair calls for change

The chair of Lloyd's of London called on the UK government to reform the corporate tax regime for insurers to prevent further erosion in the sector and mitigate further losses of business to lower-tax domiciles.[19] Speaking at the Lloyd's annual City Dinner, Lord Peter Levene noted, "the future success of Lloyd's is threatened by competition from other markets, notably offshore centers with tax rules that are very attractive to insurers."

17 *Insurancewide.com Services Ltd v. Revenue & Customs* ([2007] UKVAT V20394).

18 *Id.*

19 Stuart Collings, *Lloyd's hits U.K. taxes; Leader also criticizes insurers' pricing 'madness'*, BUSINESS INSURANCE, September 8, 2008.

The decision applied in particular to advertising/promotional type services such as internet click-through services and mail-shot and leaflet distribution services where the provider does little more than put one party in touch with the other and plays no part in any interaction between the parties once that introduction has been made. Such services are specifically excluded from the VAT exemption and are taxable regardless of whether the products are promoted in the name of the provider of the service, the provider is an insurance agent or broker by profession, or payment is made by fee or commission. Her Majesty's Revenue and Customs (HMRC) department states that in circumstances where the provider is clearly acting as an agent of an insurer or insurers and is playing a more active role in arranging the policies than mere introduction, the VAT exemption continues to apply.

Insurance Tax Review 2007/2008[20]

The second annual PwC UK Insurance Tax Review highlights major developments in 2008 that tax preparers should be aware of when advising clients doing business in the United Kingdom. Among the highlights:

- HMRC is firm about retaining the new rules streaming of forward pension business.
- The Crown option, a system requiring a life insurance company to self-assess its corporate tax liabilities using either the "'I minus E"' basis (income and gains less expenses) or under the provisions of Case I of Schedule D, was abolished in 2007. The I-E basis is mandatory for life insurers except for certain pure insurers and life insurers.
- Section 83XA Finance Act of 1989 provides that structural assets held in a nonprofit fund are now treated as shareholder fund assets subject to the normal corporate tax rules and taxed at the full corporate tax rate. The new structural asset rules are to be welcomed as the new rules align the tax system with the commercial reality.
- The targeted anti-avoidance rule (TAAR), enacted in 2007, relates to long-term insurance business transfers taking effect on or after July 1, 2008. The new rule generally provides a series of rules that apply a tax on previously nontaxed assets leaving a long-term fund and not transferred to another long-term fund.
- For policyholders, changes to the capital gains tax (CGT) from 22 percent to 20 percent may affect the competitiveness of life policies as investments, while changes to the basic rate will affect net personal pension contributions and relief for source claims by insurers.

20 *Insurance Tax Review 2007/2008*, PricewaterhouseCoopers LLP, Insurance Tax Team, February 2008.

Domestic asset and liability percentages

IRS issues new percentages[21]

In Rev. Proc. 2008-53, the IRS provided the domestic asset/liability percentages and domestic investment yields needed by foreign insurance companies to compute their minimum effectively connected net investment income under Section 842(b) for taxable years beginning after December 31, 2006.

The procedure provides instructions for computing foreign insurance companies' liabilities for the estimated tax and related installment payments for taxable years beginning after December 31, 2006.

For the first taxable year beginning after December 31, 2006, the domestic asset/liability percentages are:

- 124.4 percent for foreign life insurance companies
- 197.1 percent for foreign property and liability insurance companies

For the first taxable year beginning after December 31, 2006, the domestic investment yields are:

- 4.9 percent for foreign life insurance companies
- 4.2 percent for foreign property and liability insurance companies

21 Rev. Proc. 2008-53.

07

Blue Cross Blue Shield

Introduction

One of the few areas in which the IRS and the courts provided guidance for Blue Cross Blue Shield (BCBS) entities this year related to the tax issues arising from conversion transactions. The IRS and court guidance issued during 2008 was in line with the IRS's long-standing position on the deductibility of conversion payments.

In a memorandum opinion issued by the US Tax Court, the court looked to the "origin-of-claim" doctrine to determine the deductibility of "conversion" payments made to resolve state lawsuits arising after the conversion of three insurance companies from nonstock, nonprofit organizations to stock, for-profit organizations. The court found that WellPoint could not deduct the legal and professional expenses incurred to defend against these lawsuits, holding that the settlement payments, litigation, and professional fees were capital expenditures and therefore not deductible under Section 162(a).

Blue Cross Blue Shield conversions

IRS' view of nonprofit to for-profit[1]

In LMSB 04-0408-024, the IRS issued a coordinated issue paper that outlined its primary and alternative positions on the federal tax consequences resulting from conversions from nonprofit to for-profit status by Section 833 BCBS organizations.

BCBS plans were originally established as tax-exempt, nonprofit organizations. However, the Tax Reform Act of 1986 and subsequent legislation changed the status of BCBS organizations from tax-exempt to taxable. To ease the transition into taxability, Congress granted BCBS entities special tax benefits. Many BCBS plans have maintained the same legal status as nonprofit or public benefit corporations, but some converted to charitable trust organizations, while others converted to for-profit stock companies. State regulators commonly assert that such conversions should result in a payment or transfer by the organization to the state for the value that grew during nonprofit years. Several BCBS plans claimed tax deductions for the payments or value transfers made. The IRS arguments for disallowing the deductions include:

- No deduction for trustee transfer: A payment or transfer in satisfaction of a charitable trust obligation is a nonrecognizable transaction. As trustee, the transferor has no taxable interest in assets that are charged with a charitable trust.
- No deduction for a capital expenditure: To the extent the transaction is recognizable, the deduction should be considered a capital expenditure connected with the restructuring or reorganization of the taxpayer from a nonprofit to a for-profit entity rather than an ordinary and necessary business expense.

1 LMSB-04-0408-024.

- No deduction for expenses allocable to tax-exempt income: Under certain circumstances, to the extent a payment or transfer is associated with the taxpayer's nonprofit activities or nonprofit status during a period when it was exempt from federal income tax, Section 265 would deny a deduction.
- No deduction for fees and expenses where the fair market value of stock is transferred in a conversion transaction: In some cases, a nonprofit or public benefit organization transfers stock in satisfaction of a charitable trust obligation. However, no deduction is allowed once the charitable trust obligation is satisfied.
- Where no deduction is claimed or allowed at the time of a conversion payment, no deduction is allowed at the time of a subsequent merger or acquisition: In some cases, a nonprofit or public benefit organization makes a payment or transfer for value in satisfaction of a charitable trust obligation, and later merges with or is acquired by a for-profit organization. The initial transfer is considered a nonrecognizable transaction and no deduction is allowable at any time.

It appears the release of the coordinated issue paper is the IRS's attempt to ensure taxpayers understand that the related guidance remains active and applies to a broad range of situations. Although it discusses the conversion of BCBS organizations, the position described may apply to any taxable nonprofit organization that converts to for-profit status.

Origin-of-claim doctrine[2]

In *WellPoint, Inc. v. Commissioner*, the Tax Court looked to the "origin-of-claim" doctrine to determine the deductibility of conversion payments made to resolve state lawsuits arising after conversion of three insurance companies from nonstock, nonprofit organizations to stock, for-profit organizations located in Connecticut, Kentucky, and Ohio. The court also applied the doctrine to determine the deductibility of legal and professional expenses incurred defending against these lawsuits. Based on its analysis of the origin-of-claim doctrine, the court held that the settlement payments, litigation, and professional fees were capital expenditures and therefore not deductible under Section 162(a).

Under the origin-of-claim doctrine, the substance of the underlying claim or the transaction producing the expenditure controls whether the item is a deductible expense under Section 162(a) or a capital expenditure. The determination is made irrespective of the payor's intent in making the payment. Likewise, the origin of claim does not involve a "mechanical search for the first in the chain of events," but requires consideration of the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the amounts claimed as deductions were expended, and all other facts relating to the litigation.

2 *WellPoint, Inc. v. Commissioner*, T.C. Memo 2008-236 (2008).

In its analysis, the Tax Court stated that the predominant claim in each of the lawsuits was based upon a "cy-pres" claim, which is an equitable claim based upon the rule of construction of an intent when it is illegal or impossible to give the literal meaning. Under the cy-pres doctrine, if property has been dedicated in trust for a particular charitable purpose that is not being carried out, a state attorney general is authorized to commence a cy-pres proceeding to carry out the charitable purpose in a way that is "as near as" possible to the original purpose.

Each attorney general insisted that the state BCBS entity had a charitable purpose, received beneficial treatment under state and federal law because of that purpose, and were therefore impressed with a charitable trust. They contended that the entities' charitable purposes were no longer being met and that the charitable assets that had accumulated should be taken from the entities' control and redirected to carry out the same charitable purpose.

The Tax Court provided that since the attorneys general brought suit to recover equitable title to assets they thought were impressed with charitable trusts, the "origin of claim" was, in fact, over the title to the assets in all three lawsuits. Relying on its own precedent, the court noted that the "costs incurred in defending against claims challenging a taxpayer's ownership of assets" were also capital expenditures.

The Tax Court looked past the mere intention of a taxpayer in determining the treatment of payments and determined that the origin of the claim arose in connection with the defending of title to the assets. The ruling supports the IRS's stated view that conversion payments should not be deductible payments.

Monetizing unused AMT R&D credits

New legislation provides incentives[3]

On July 30, 2008, former President Bush signed the Housing and Economic Recovery Act of 2008 (HERA). The HERA includes a provision allowing an election to accelerate unused alternative minimum tax (AMT) and research and development (R&D) credits in lieu of the 50 percent "bonus" depreciation enacted in February 2008 as part of the Economic Stimulus Act of 2008. The HERA is of interest to BCBS entities with AMT credit carryforwards because it provides an opportunity to monetize credits that would otherwise go unused. The provisions are discussed in Section 168(k)(4) of the Internal Revenue Code, and are effective for taxable years ending after March 31, 2008.[4]

3 Presenters Kendall Fox, George Manousos, and Jim Shanahan, "Election to Monetize Unused Research & AMT Credits," Washington National Tax Services (WNTS) Webcast Series, "Election to Monetize Unused Research & AMT Credits," PricewaterhouseCoopers LLP, August 14, 2008.

4 *Id.*

In general, for property to qualify for the additional first-year depreciation deduction, a company must meet all of the following requirements:

1. The property must be:
   - Property to which the Modified Accelerated Cost Recover System (MACRS) applies with an applicable recovery period of 20 years or less
   - Water utility property (as defined in Section 168(e)(5))
   - Computer software other than computer software covered by Section 197
   - Qualified leasehold improvement property (as defined in Section 168(k)(3))
2. The original use of the property must commence with the taxpayer after December 31, 2007.
3. The taxpayer must purchase the property either:
   - After December 31, 2007 and before January 1, 2009, but only if no binding written contract for the acquisition is in effect before January 1, 2008
   - Pursuant to a binding written contract entered into after December 31, 2007 and before January 1, 2009
4. The property generally must be placed in service after December 31, 2007 and before January 1, 2009.[5]

The credits are limited to the bonus depreciation amount allowed or allowable for any taxable year.[6] For tax purposes, many BCBS plans in loss positions would generally not receive a current tax benefit from bonus depreciation, but the addition of this provision may allow plans in a loss position with significant AMT or R&D credit carryforwards to benefit. This would make sense if a plan's tax posture was such that the cash benefits of converting the depreciation deductions into currently usable and refundable credits exceed the present value of any foregone accelerated depreciation.

5 *Id.*

6 Federal Housing Finance Regulatory Reform Act of 2008, Pub. L. 110-289, sec. 3081 (2008).

08

Products

Introduction

The IRS issued five revenue procedures outlining how companies can restore failed life insurance contracts. These revenue procedures outlined the IRS's focus on changes to correction procedures and alternative computations required for model closing agreements, eliminated certain informational requirements, and provided new or revised model closing agreement language. Moreover, the IRS continued to grant waivers to taxpayers who failed to meet certain requirements of an insurance contract where the taxpayer showed that they acted reasonably and in good faith, and that reasonable steps had being taken to remedy the error.

The IRS issued final Section 6039I[1] regulations that replaced previously issued temporary regulations and released Form 8925, *Report of Employer-Owned Life Insurance Contracts*, which is required to be filed by policyholders that own corporate-owned life insurance (COLI). The IRS finalized guidance for issuers of life and variable insurance contracts and addressed the application of Sections 101(j) and 264(f) to life insurance contracts that are subject to split-dollar life insurance arrangements. Finally, the IRS reiterated that there must be both risk-shifting and risk-distribution in order to constitute insurance, and that economic substance will continue to be one of the components considered in determining the existence of insurance risk.

Failed contracts

New IRS guidance[2]

In five new rulings this year, the IRS issued guidance for issuers of life and variable insurance contracts.

Rev. Proc. 2008-38 provides a procedure by which an issuer of a life insurance contract may remedy a failure to account for charges for qualified additional benefits (QABs) under the expense charge rule of Section 7702(c)(3)(B)(ii). This Rev. Proc. incorporates certain changes to Rev. Rul. 2005-6, which sets forth alternative correction procedures for issuers whose compliance systems do not currently account for charges for QABs under the expense charge rule of Section 7702(c)(3)(B)(ii). Rev. Proc. 2008-38 provides a model closing agreement and explains in detail the applicable terms and conditions.

Rev. Proc. 2008-39 provides a procedure by which an issuer of a life insurance contract may remedy an inadvertent, nonegregious failure to comply with the modified endowment contract (MEC) rules under Section 7702A. This Rev. Proc. incorporates certain changes to Rev. Proc. 2001-42 that include providing an alternative computation of the amount required to be paid under a closing agreement with regard to an inadvertent MEC, eliminating certain informational items that must be submitted, and revising some model closing agreement language.

1 T.D. 9364.
2 Rev. Procs. 2008-38, 2008-39, 2008-40, 2008-41, and 2008-42.

Rev. Proc. 2008-40 provides a procedure by which an issuer of a life insurance contract may remedy the failure of one or more contracts to meet the definition of a life insurance contract under Section 7702(a) or to satisfy the requirements of Section 101(f). This Rev. Proc. incorporates certain changes to the existing correction procedures. Rev. Proc. 2008-40 sets forth a model closing agreement for issuers that seek relief and provides alternative calculations of the amount due under the closing agreement.

Rev. Proc. 2008-41 provides a procedure by which an issuer of a variable contract may remedy an inadvertent failure of a variable contract to satisfy the diversification requirements of Section 817(h). This Rev. Proc. incorporates certain changes to the existing correction procedures. Rev. Proc. 2008-41 updates the model closing agreement set forth in Rev. Proc. 92-25 and provides both an alternative computation of the amount due under the closing agreement and an overall limit on the amount that must be paid.

Rev. Proc. 2008-42 provides a procedure by which an issuer of a life insurance contract may automatically obtain a waiver, under Section 7702(f)(8) or Section 101(f)(3)(H), for certain reasonable errors that caused the contract to fail to satisfy the requirements of Section 7702 or Section 101(f), as applicable. This Rev. Proc. incorporates certain changes to the existing correction procedures. Rev. Proc. 2008-42 provides a simplified procedure under which a taxpayer may obtain a waiver for a limited class of errors under these provisions without incurring the cost of requesting a letter ruling.

Waiver of failed contracts[3]

In PLR 200819003, the IRS ruled that the failure of a life insurance company's policies to meet the definition of a life insurance contract under Section 7702(a) was due to a reasonable error, and granted the company a waiver under Section 7702(f)(8) for any contracts that are cured within 90 days of the ruling.

Taxpayer was a stock life insurance company with approximately Number F policies currently in force, of which Number G were universal life policies. Although Taxpayer intended that each of its life insurance policies meet the definition of a life insurance contract under Section 7702 by satisfying the guideline premium limitation, Taxpayer later discovered errors that resulted in the failure of Number H Contracts, all of which were issued after 1985. Taxpayer had previously used a manual system of ensuring that its contracts were in compliance with Section 7702, but had since converted to using an automated administrative system to improve compliance. Taxpayer would also bring the contracts into compliance by making refunds of premium, including interest on the premium amount calculated at the contract rate, to each contract holder.

To satisfy this definition, a life insurance or endowment contract must be treated as such under the applicable law and satisfy either (1) the cash value accumulation (CVA) test of Section 7702(a) and Section 7702(b); or (2) both the "guideline premiums requirements" of Section 7702(a) and Section 7702(c), and fall within the "cash value corridor test" of Section 7702(a) and Section 7702(d). Section 7702(f)(1)(B) generally provides that, if the

3 PLRs 200819003, 200838018, 200841034.

premiums paid exceed the guideline premium limitation, and the issuer refunds the excess (with interest) within 60 days after the end of the policy year, then the amount returned (without interest) is deemed to reduce the sum of the premium paid under the contract during the year.

In this case, the failure of Number H Contracts to satisfy the requirements of Section 7702(a) was caused by reasonable error. In addition, Taxpayer instituted procedures to reduce or eliminate the likelihood that such errors would recur and took reasonable steps to remedy the failure of the contracts. Accordingly, the failure was waived pursuant to Section 7702(f)(8). However, contracts not cured within 90 days of the IRS's notice are not covered by the waiver.

In PLR 200838018, the IRS ruled that failure of a life insurance company's policies to meet the federal tax definition of life insurance contracts under Section 7702 was due to a reasonable error and that the company qualified for a waiver of reasonable errors because it took corrective steps.

Taxpayer was a life insurance company whose policies were intended to qualify as life insurance contracts under Section 7702 by satisfying the guideline premium requirement of Section 7702(a)(2)(A) and (c) and by falling within the cash value corridor of Section 7702(a)(2)(B) and (d). The policies' death benefits were decreased at the request of the policy owners, but no refunds of premiums paid were required at that time. The adjustments resulted in negative guideline annual premiums, which caused the guideline premium limitations to grow smaller in subsequent policy years until there were excess premiums paid over the recomputed guideline premium limitations. The insurer instituted monitoring procedures to ensure compliance and the computer system generated a code to alert personnel of a guideline error for each policy. However, due to miscommunication between two offices, nothing was done to bring the policies into compliance.

According to the IRS, except for the Number B Policies, all other policies were brought into compliance within the timeframe mandated under Section 7702(f)(1)(B). Taxpayer refunded excess premiums (with interest) as required by Section 7702(f)(8)(b) and was instituting procedures to reduce the likelihood that such errors would recur. After considering all the facts and circumstances, the IRS found that failure of the policies to satisfy the requirements of Section 7702 was due to reasonable error and granted a waiver pursuant to Section 7702(f)(8). Taxpayer also implemented new safeguards and additional oversight to prevent future noncompliance.

In PLR 200841034, the IRS granted an insurer a waiver on the failure of life insurance contracts to satisfy the CVA test of Sections 7702(a)(1) and 7702(b). Taxpayer issued Number Z individual, nonparticipating, flexible premium variable life insurance contracts (Contracts) designed to satisfy the requirements of the CVA test after December 31, 1984, Section 7702's effective date. The "cash value" of each Contract reflected (1) net premiums paid under the Contract; (2) cost of insurance charges; (3) any increases or decreases as a result of market performance in the variable subaccounts; (4) the amount of any partial surrenders; (5) policy indebtedness; and (6) all other fees, deductions, and charges assessed under the Contract. Each Contract provided a minimum death benefit calculated by multiplying the Contract's "cash value" by a percentage identified in the Contract. The applicable percentage intended to equal the amount required to maintain the Contract's compliance with the CVA test at all times.

In limited circumstances, upon full surrender, Taxpayer paid the Contract owner certain amounts (remittances) representing a portion of premium loads assessed in the year of surrender, in addition to the Contract's "net cash value." Under the Contracts, the "net cash value" on the surrender date equaled the "cash value" on that date less any outstanding policy indebtedness. Under the Contract terms, the amount of a potential remittance was not included in the Contract's "cash value," and Taxpayer did not treat the remittances as part of the "cash value" in administering the Contracts. Exclusion of the remittance from a Contract's "cash value" meant the minimum death benefit under the Contract during the first three Contract years (i.e., the period in which the remittance was payable) was less than what it would be if the remittance were included in the "cash value."

Taxpayer's failure to include the amount of a potential remittance in the Contracts' "cash value" caused an error under the CVA test, in that the Contracts did not ensure that their Section 7702(f)(2) cash surrender value did not at any time exceed the net single premium that would have to be paid at such time to fund future benefits under the Contract. Taxpayer corrected the error caused by the remittance.

In Notice 93-37, the IRS announced that the effective dates of the proposed regulations under Section 7702 would be no earlier than the date of publication of final regulations in the Federal Register. The notice also indicated that insurance companies generally would be allowed time after final regulations were published to bring their contracts into compliance with any new rules.

According to the IRS, the remittance that could be payable under a Contract should have been included as part of the Contract's cash surrender value within the meaning of Section 7702(f)(2)(A). Because the Section 7702 proposed regulation's definition of cash surrender value is not identical to the definition in Section 7702's legislative history, and because the proposed regulations had not been finalized, the IRS concluded that the Contracts' failure to satisfy the requirements of the CVA test was waived because it was due to reasonable error and Taxpayer's method of remedying the errors was reasonable. Additionally, the IRS ruled that Taxpayer's addition of a corrected endorsement to the Contracts to comply with the CVA test did not affect the Contracts' issue dates or the dates upon which they are considered to have been entered into, and did not result in a material change or exchange for federal income tax purposes.

In *Kenneth F. Reinert v. Commissioner*[4], the Tax Court held that the termination of a petitioner's life insurance policy triggered income and a liability for an accuracy-related penalty assessed by the IRS.

4 T.C. Summary Opinion 2008-163.

Petitioner purchased a life insurance policy with the Northwestern Mutual Life Insurance Co. (Northwestern). Petitioner borrowed against the cash surrender value, which continued to increase, but did not pay interest on the loans outstanding. Northwestern treated the interest as additional loans against the cash value of the policy, which stipulated, "If indebtedness equals or exceeds the cash value at any time, his policy shall terminate thirty-one days after a notice of termination has been mailed to…the Owner." In December 2004, Northwestern sent Petitioner a notice stating that the loan amount would soon exceed the cash value and that the policy would "terminate," triggering ordinary income. Petitioner did not pay the interest. The loan amount exceeded the policy cash value and the policy was terminated. In February 2005, Petitioner received a form titled "Surrender of Policy for Cash Value" along with a $1,269.57 check from Northwestern, the difference between the cash value of the policy (which had increased to $29,933.78 by termination) and the $28,664.21 outstanding loan and interest against cash value. Petitioner signed the form and endorsed and cashed the check. None of the cash value was distributed to Petitioner as a dividend or distribution, resulting in no tax on the increase between 1958 and 2005. Petitioner received a Form 1099-R for his 2005 tax year reflecting a gross distribution of $29,933.78 and a taxable amount of $21,248.18. The difference of $8,685.60 was the total amount Petitioner had paid in premiums. Petitioner was effectively relieved of $28,664.21 in loans over the 47-year policy life.

Petitioner argued that a policy "termination" was not a taxable event because the relevant statutes and regulations expressly applied to a "surrender" of policy, relying on dictionary definitions. Since the statute and the regulations used the term "surrender" but not "termination," Petitioner argued that Congress intended that amounts received in excess of investment due to termination were not includable in his gross income, but did not provide any reference to legislative history in support of his contention. The court noted that in *Atwood v. Commissioner*,[5] a case with similar circumstances to Petitioner's, the excess of the cash surrender value over total premiums was held to be ordinary income.

Section 72(e) causes the increases in value of insurance contracts to be taxable when the policy ends prior to the payment of an annuity, permitting the deferral of the reporting of income until a triggering event occurs, a purpose for which the Tax Court saw no distinction between the termination and surrender of an insurance policy. Petitioner did not disclose or explain why the amounts shown on the Form 1099-R were not reported on his 2005 return. Therefore, the court determined that Petitioner was liable for a section 6662(a) accuracy-related penalty on the underpayment of tax for his 2005 tax year.

5 T.C. Memo. 1999-61.

Corporate-owned life insurance

Final regulations under Section 6039I[6]

The IRS issued final regulations under Section 6039I, replacing temporary regulations issued on November 13, 2007 regarding information reporting on employer-owned life insurance contracts to provide taxpayers guidance in applying Section 6039I requirements. Effective for tax years ending after November 6, 2008, the final regulations generally require applicable policyholders owning one or more employer-owned life insurance contracts issued after August 17, 2006 to file a return showing the following information for each year such contracts are owned:

- The number of employees of the applicable policyholder at the end of the year
- The number of such employees insured under such contracts at the end of the year
- The total amount of insurance in force at the end of the year under such contracts
- The name, address, and taxpayer identification number of the applicable policyholder and the type of business in which the policyholder is engaged
- That the policyholder has a valid consent for each insured employee (or, if not all such consents are obtained, the number of insured employees for whom such consent was not obtained)

Applicable policyholders must provide the information required under Section 6039I by attaching Form 8925, “Report of Employer-Owned Life Insurance Contracts,” to the policyholder’s income tax return by the due date of that return.

Corporate-owned life insurance (COLI) must now satisfy statutory requirements in order to maintain its tax-favored status. In general, the insured (1) must be notified in writing before the policy is issued of the policyholder’s intention to insure their life and the maximum face value/death benefit for which they will be insured, (2) must sign a consent to being insured, and (3) must be notified in writing that the policyholder will be the beneficiary of any death proceeds. Employers must complete Form 8925 to comply with their annual reporting requirements under Sections 6039I and 101(j).

Statute of limitations expires for Wal-Mart

Wal-Mart Stores Inc. lost a battle to toll the three-year statute of limitations in its case against AIG Life Insurance Co. to recover damages for tax liabilities suffered as a result of life insurance policies bought by Wal-Mart between 1993 and 1995. A superior court judge opined that the retailer was a sophisticated party who knew the risks surrounding COLI policies over three years before suing in 2002. Wal-Mart claimed that it did not know that the COLI plans were different from standard life insurance policies, but the defense pointed out that Wal-Mart hired a law firm “specifically to advise them about these policies.”[7]

6 T.D. 9364.
7 Elizabeth Bennett, Wal-Mart Loses Statute of Limitations Fight in Superior Court, DELAWARE LAW WEEKLY, November 19, 2008.

Annuity contracts

Partial exchanges of annuity contracts[8]

In Rev. Proc. 2008-24, the IRS provided guidance on the parameters for taxpayers seeking tax-free treatment for "partial exchanges" of annuity contracts. The Rev. Proc. applies to the direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract, regardless of whether the two annuity contracts are issued by the same or different companies. The Rev. Proc. does not apply to transactions in which the holder of an annuity contract irrevocably elects to apply only a portion of the contract to purchase a stream of annuity payments under the contract, leaving the remainder of the contract to accumulate income on a tax-deferred basis.

Under Rev. Proc. 2008-24, a transfer will be treated as a tax-free exchange under Section 1035 if (1) no amounts are withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 12 months beginning on the date on which amounts are treated as received as premiums or other consideration paid for the contract received in the exchange (the date of the transfer); or (2) the taxpayer demonstrates that one of the conditions described by Section 72 or any similar life event occurred between the date of the transfer and the date of the withdrawal or surrender.

The IRS will look at a period of only one year to determine whether single-transaction treatment is warranted. Under this new guidance, direct transfers of part of a contract for a second contract must qualify as a tax-free exchange under Section 1035 as well as the rules set forth in Rev. Proc. 2008-24, or they will be treated as taxable distributions followed by a payment for the second contract. The IRS stated that it would not require aggregation of two contracts in a tax-free exchange subject to Section 1035 if no amounts are withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 12-month period beginning when the first premiums are paid. Rev. Proc. 2008-24 supersedes previous interim rules under Notice 2003-51.

IRS requested to reverse or delay imposing position on Notice 96-8

Faegre & Benson LLP urged the IRS to reverse its position requiring variable annuity plans to comply with the general principles of Notice 96-8, or in the alternative, delay the imposition of the requirements.[9] The letter asserted that since many professional firms adopted variable annuity plans assuming that the general principles of Notice 96-8 did not apply, the IRS should delay requiring compliance with the general principles of Notice 96-8 for a time period sufficiently long to terminate such plans while still being recognized as tax qualified by the IRS.

8 Rev. Proc. 2008-24.

9 Hubert Forcier, Law Firm comments on Aspects of Proposed Hybrid Retirement Plan Regs. Addressing Variable Annuity Plans, TAX NOTES TODAY, 2008 TNT 158-7, August 5, 2008.

Charitable organization's sale of annuities is unrelated business income[10]

In PLR 200852037, the IRS held that a charitable organization's (ORG's) sale of annuities through a charitable gift annuity program would not constitute commercial-type insurance under Section 501(m), and that income from the program will not constitute income from an unrelated business under Section 513.

ORG, a public charity, was proposing a charitable gift annuity (CGA) program mainly to raise funds for its charitable activities. ORG would offer a gift annuity to an individual (Donor) for less than 90 percent of the cash or value of property received from Donor. ORG would make periodic annuity payments to Donor based on the life or lives of the Annuitants when the annuity is issued. ORG's annuity payments to Donor would be the only consideration ORG would provide to Donor in return for Donor's contributions to the charity. No minimum or maximum amount of payments would be guaranteed to Donor in the CGA contract. The CGA contract would not allow adjustments to the annuity payments by reference to the funds received from Donor.

ORG would insure its annuity obligation to Annuitant by purchasing a commercial annuity from a major insurance company (Insurer). The premiums that ORG would pay to Insurer would be less than the premium received from Donor. ORG would retain the difference in premium for its use. ORG may receive a lump sum refund from Insurer if Annuitant dies before annuity payments exceed premium payments to Insurer.

On review of the facts and circumstances provided by ORG, the IRS concluded that the sale of annuities through the CGA program would not constitute commercial-type insurance under Section 501(m), and that the difference in premiums retained, the annuity payments from Insurer, and any lump sum refund from Insurer would not constitute income from an unrelated business under Section 513.

Final regulations on converting an IRA annuity to Roth IRA[11]

The IRS released final regulations under Section 408A that provide guidance on the tax consequences of converting a non-Roth individual retirement annuity to a Roth IRA. The final regulations apply to any Roth conversion where an annuity contract is distributed or treated as a distribution from a traditional IRA or savings incentive match plan for employees (SIMPLE) IRA. According to the IRS, the converted amount must be included in a taxpayer's income for the year in which the conversion occurred. Conversions to Roth IRAs are limited to taxpayers with modified adjusted gross income of $100,000 or less, including the conversion amounts, and, if married, to those filing jointly, until after 2009.

10 PLR 200852037.
11 T.D. 9418.

According to the final rule, when an IRA annuity contract is converted to a Roth IRA, the amount treated as a distribution must be the fair market value of the annuity contract on the date the contract is converted. Similarly, when a traditional IRA account holds an annuity contract as an asset, the amount treated as a distribution must be the fair market value of the annuity contract on the date the annuity contract is distributed or treated as distributed from the traditional IRA.

The final rule clarifies that when a conversion is made by surrendering an annuity without retaining or transferring rights, the amount converted, and hence the amount that must be included in income as a result of the conversion, is limited to the surrendered cash value (the actual proceeds to be deposited into the Roth IRA). Rev. Proc. 2006-13 provided that, in such a case, the valuation methods in the temporary regulations do not apply. A second change determined the fair market value of the annuity to be the dollar value of premiums paid for comparable annuity contracts, if a conversion occurred soon after the annuity was sold. Although the final regulation applies to conversions made on or after August 19, 2005, taxpayers may instead apply the valuation methods in the temporary regulation and in Rev. Proc. 2006-13 for annuity contracts distributed from a traditional IRA on or before December 31, 2008.

Split-dollar

Modification of arrangements[14]

In Notice 2008-42, the IRS addressed the application of Sections 101(j) and 264(f) to life insurance contracts that are subject to split-dollar life insurance arrangements. Under this notice, a modification of a split-dollar life insurance arrangement that does not entail any change to the life insurance contract underlying the arrangement will not be treated as a material change in the life insurance contract for purposes of Sections 101(j) and 264(f).

Section 101(j)(1) generally provides that death benefits from an employer-owned life insurance contract in excess of premiums paid are taxable unless certain exceptions are met. Section 101(j) applies to life insurance contracts issued after August 17, 2006. Contracts issued after thatdate pursuant to a Section 1035 exchange for a contract issued on or before that date are not considered to be new contracts unless there is a material change to the contract. Otherwise, contracts issued on or before August 17, 2006 are grandfathered and not subject to the requirements of Section 101(j).

Section 264(f)(1) generally eliminates a taxpayer’s deduction for the portion of the taxpayer’s interest expense that is allocable to unborrowed policy cash value with respect to a life insurance policy or an annuity or endowment contract. Section 264(f) applies to contracts issued after June 8, 1997. Any material increase in the death benefit or other material change in the contract issued before this date is treated as a new contract. Otherwise, contracts issued on or before June 8, 1997 are grandfathered and not subject to the requirements of Section 264(f).

14 Notice 2008-42.

The IRS noted that Sections 101(j) and 264(f) apply to "life insurance contracts," as defined in Section 7702, which generally does not encompass split-dollar arrangements, of which the contract is a part. According to the IRS, if the parties to a split-dollar life insurance arrangement modify the terms but do not modify the terms of the life insurance contract underlying the arrangement, the modification will not be treated as a material change in the life insurance contract for purposes of Section 101(j) and 264(f), even if the modification is treated as a material modification of the split-dollar arrangement for purposes of Section 1.61-22(j).

Request for comments

Shortly after Notice 2008-42, the IRS announced that they were soliciting comments concerning an existing final regulation[15] regarding income, employment, and gift taxation of split-dollar life insurance arrangements.[16] The deadline for comments was June 9, 2008.

Diversification requirements

Final regulations under Section 816[17]

The IRS issued final regulations on the diversification requirements of Section 817(h) that expand the list of holders whose beneficial interests in an investment company, partnership, or trust do not prevent a segregated asset account from looking through to the entity's assets.

Section 817(h)(1) provides that a variable contract based on a segregated asset account is not treated as an annuity, endowment, or life insurance contract unless the segregated asset account is adequately diversified in accordance with regulations prescribed by the Secretary. If a segregated asset account is not adequately diversified for a calendar quarter, then the contracts supported by that segregated asset account are not treated as annuity, endowment, or life insurance contracts for that period and subsequent periods, even if the segregated asset account is adequately diversified in those subsequent periods. Under Reg. Section 1.817-5(a), if a segregated asset account is not adequately diversified, income earned by that segregated asset account is treated as ordinary income received or accrued by the policyholders. Section 817(h)(4) also provides a look-through rule under which taxpayers do not treat the interest in a regulated investment company (RIC) or trust as a single asset of the segregated asset account, but rather apply the diversification tests by taking into account the assets of the RIC or trust. Section 817(h) further provides that the look-through rule applies only if all of the beneficial interests in a RIC or trust are held by one or more insurance companies (or affiliated companies) in their general account or segregated asset accounts, or by fund managers (or affiliated companies) in connection with the creation or management of the RIC or trust.

15 T.D. 9092.
16 73 F.R. 19588-19589.
17 T.D. 9385.

The final regulations adopt with minor revisions, the proposed regulations that were published in July 2007. Specifically, the regulations expand the list of permitted investors in Reg. Section 1.817-5(f)(3) to include (1) qualified tuition programs as defined in Section 529; (2) trustees of foreign pension plans established and maintained outside the United States, primarily for the benefit of individuals, substantially all of whom are nonresident aliens; and (3) accounts that, pursuant to Puerto Rican law or regulation, are segregated from the general asset accounts of the life insurance companies that own the accounts, provided the requirements of Section 817(d) and (h) are satisfied (without regard to the requirement the accounts be segregated pursuant to "state" law or regulation).

No violation of Section 817(h) for money markets[18]

In Notice 2008-92, the IRS has issued guidance providing that an insurance-dedicated money market fund's participation in Treasury's Temporary Guarantee Program for Money Market Funds will not result in a violation of the Section 817(h) diversification requirements in the case of a segregated asset account that invests in the insurance-dedicated money market fund. In general, under the program, the Treasury Department is making available its Exchange Stabilization Fund on a temporary basis to help participating money market funds repay shareholders upon liquidation of their shares. The program is limited to assets in money market funds as of the close of business September 19, 2008, and to investors of record as of that date. The program is available to both insurance-dedicated money market funds and money market funds that are available to the general public.

Under the notice, Treasury and the IRS will not assert that participation in the guarantee program by an insurance-dedicated money market fund causes a violation of the diversification requirements of Section 817(h) in the case of a segregated asset account that invests in the insurance-dedicated money market fund. In addition, Treasury and the IRS will not assert that such a fund's participation in the program causes the holder of a variable contract supported by a segregated asset account that invests in the fund to be treated as an owner of the fund.

Some practitioners have expressed concern that participation in the program may raise certain potential tax issues for insurance-dedicated money market funds—that is, money market funds whose beneficial interests are held exclusively by one or more segregated asset accounts of one or more insurance companies (or other investors permitted under Reg. Section 1.817 5(f)(3)).

Plan to study life insurance policy taxation

Insurance Studies Institute President and CEO Paul Siegert provided the Treasury with a report entitled "Taxation of Life Insurance Companies in an Evolving Secondary Marketplace." This report is a "prelude" to a larger economic/tax revenue study involving life settlements that Siegert discussed with Secretary Hank Paulson in early 2008, highlighting as a major issue the significant misunderstanding surrounding the taxation of life insurance products when sold as settlements.[19]

18 Notice 2008-92.
19 Paul Siegart, *Taxation of Life Insurance Policies in an Evolving Secondary Marketplace*, TAX NOTES TODAY, 2008 TNT 59-13, March 7, 2008.

Manufacturer's warranty contracts

Extended service contracts[20]

In PLR 200843026, the IRS ruled that a company issuing extended vehicle contracts was an insurance company under Section 831(c). The contracts, which were insurance contracts containing, inter alia, indemnification agreements between the company and an unrelated insured, were considered to be reinsurance contracts for federal income tax purposes.

Taxpayer was a wholly owned subsidiary of Parent, who operated as a third-party administrator of vehicle service contracts (also known as "extended warranty contracts") issued by unrelated insurance companies. Taxpayer began issuing service contracts (Contracts) providing protection to holders against losses for certain expenses related to vehicle repair not covered by the manufacturer's warranty covering replacement vehicle rental expense and towing and road service incurred as a result of a covered breakdown, but did not cover routine or preventative maintenance. Taxpayer did not perform repair services, but rather only reimbursed repair facilities or the holder of the contract. If the Contracts were cancelled, Taxpayer would be obligated to reimburse any unearned premiums. The Contracts were sold by retail automobile dealers. The full premium was collected at sale and remitted to Taxpayer less the dealer's commission. Taxpayer entered into an agreement (Agreement) with unrelated Company E where Company E agreed to indemnify Taxpayer for 100 percent of claims made under the Contracts.

In PLR 200845043, the IRS ruled that (1) the extended service contracts (ESCs) issued by Newco would be treated as insurance contracts; and (2) Newco would be treated as an insurance company for federal income tax purposes. Taxpayer was incorporated and headquartered in State X and was the parent of an affiliated group (including Newco) that filed a consolidated return. Newco was incorporated in State Z. Taxpayer sold consumer products accompanied by a manufacturer's warranty. Taxpayer also offered ESCs with its products, the terms of which varied with the product covered and whose duration began after the manufacturer's warranty expired.

Taxpayer wanted to move its ESC business to Newco, which would not assume any of Taxpayer's existing ESCs and would issue and administer ESCs only when it was named the contractual administrator and obligor. Taxpayer represented that the affiliated company would be a licensed State Z captive insurance company and that there would be no overlap between its manufacturer's warranty and the Newco ESCs. Newco would also enter into selling agreements with third-party wholesalers, resellers, and value-added resellers and establish suggested retail prices for the ESCs. Newco expected to purchase reinsurance, at arms-length consideration, from an affiliated company for all or a portion of the risks on the ESCs issued by Newco under customary insurance industry terms and conditions. Newco would have officers and directors responsible for oversight but no direct employees to perform administrative functions. Newco would not perform any repair services to products itself and would service claims in one of four ways: carry-in service to a Taxpayer-owned retail store, authorized service providers, direct mail-in service, or do-it-yourself parts service. Newco would be obligated to pay for repairs or product replacements and the cost of providing technical support, but would not be liable for all damages.

20 PLRs 200843026, 200845043, 200850011.

In PLR 200850011, the IRS concluded that Taxpayer's wholly owned captive insurance subsidiary qualified as an insurance company and that ESCs it reinsured under a reinsurance contract with another one of Taxpayer's subsidiaries constituted insurance. Taxpayer was the parent of an affiliated group filing a consolidated return and was incorporated under the laws of State X. Newco was a wholly owned captive insurance subsidiary domiciled in State Y. Newco would insure certain insurance risks of Taxpayer and its affiliates and reinsure a 90 to 100 percent quota share of the risks on ESCs issued by Obligor, Taxpayer's wholly owned subsidiary who expected to sell a sizable number of ESCs based on Taxpayer's historical sales volume. Obligor had previously been established to be a Section 831(a) insurance company. Newco represented its only business activity that would be issuing direct insurance and reinsurance policies. Newco further represented that the direct insurance policies would be offered to Taxpayer and its affiliates and that arms-length rates would be charged for the reinsurance premiums, which would make up more than half of the total premiums collected by Newco. Taxpayer requested that the ESCs reinsured by Newco under the reinsurance contract with Obligor be treated as a pool of unrelated insurance risk and that Newco qualify as an insurance company.

Case law defines insurance as a contract where one party indemnifies another against loss from a specific contingency for adequate consider-ation and as one in which risk shifting and distribution is evident. Risk shifting occurs when the party facing the possibility of loss transfers some or all of the financial consequences to an insurer. In determining whether a captive insurance arrangement exists for federal income tax purposes, courts typically focus on (1) the involvement of an insurance risk, (2) risk shifting and risk distribution, and (3) the commonly accepted sense of insurance.[21] Another factor courts consider is the use of premiums that are priced at arms length.[22] In Rev. Rul. 80-95, 1980-1 C.B. 252, the IRS recognized the economic substance of the arrangement as the shifting and distribution of the employees' risk of loss from injury in holding that the indemnification agreement was an insurance contract.

In PLR 200843026, the vehicle service contracts were obligations of Taxpayer to indemnify the holder against specific losses for a fixed price. By accepting a large number of risks, Taxpayer distributed the risk of loss under the Contracts; therefore the contracts were insurance. Similarly, in PLR 200845043, the IRS concluded that Newco's ESCs were insurance contracts due to its obligation to indemnify contract holders for specified losses not covered by the manufacturer's warranty and that contract holders shifted the risk of economic loss to Newco, who distributed the risk of loss across a large number of ESC contract holders so as to make its average loss predictable. In PLR 200850011, the IRS pointed to the risk of loss being shifted to Newco and being distributed among a large number of unrelated parties purchasing Taxpayer's products and held that there was economic substance in the arrangement between Newco and Obligor to provide for the insurance risk covered under the ESCs offered by Obligor to unrelated parties.

21 *See generally*, *AMERICO, Inc. v. Commissioner*, 979 F.2d 162, 164-165 (9th Cir. 1992), aff'd 96 T.C. 18 (1981).
22 *See generally*, *The Harper Group v. Commissioner*, 96 T.C. 45, 60 (1991), aff'd, 979 F. 2d 1341 (9th Cir. 1992).

An insurance company is defined under Section 816(a) as a company that has more than half of its business during the taxable year issuing insurance, annuity contracts, or reinsurance. Reinsurance is a contract where one insured cedes to another all or part of the risk it has assumed under a separate insurance policy or group of policies. In PLR 200843026, the IRS concluded that the agreement with Company E to indemnify Taxpayer of its obligations constituted reinsurance for federal income tax purposes. In PLR 200845043, Taxpayer represented that the majority of Newco's gross receipts would come from ESCs and it would invest premiums to pay claims and generate surplus. In PLR 200845043 and PLR 200850011, the IRS held that more than half of Newco's business would be issuing ESCs that were insurance contracts, therefore qualifying Newco as an insurance company for purposes of Section 831. The IRS has consistently ruled that warranties and extended service contracts are insurance.

Warranty obligations not insurable risks[23]

In TAM 200827006, the IRS held that a multiline retailer's purchase of a warranty reimbursement insurance policies from a related captive insurance subsidiary designed to reimburse the retailer's losses under its manufacturer's warranty obligation offered to customers did not constitute insurable risks.

Taxpayer sold both products subject to a manufacturer's warranty provided to the consumer as part of the original sales transaction (Manufacturer-Branded Products) and also sold branded products made by various manufacturers that were purchased by Taxpayer, who assumed the "manufacturer's warranty" (Taxpayer-Branded Products). For the Taxpayer-Branded Products, Taxpayer agreed, in exchange for lower product costs, to repair and replace such products under the supply agreements. The warranty provided with the Taxpayer-Branded Products identified Taxpayer as the party responsible for services promised in the warranty provided to the consumer. The product manufacturer agreed to pay Taxpayer for service calls in excess of a target level. Taxpayer entered into a reimbursement policy with a wholly owned captive insurance subsidiary included in Taxpayer's consolidated return. The policies reimbursed Taxpayer for warranty expenses incurred in connection with its service obligations under the manufacturer's warranty agreements for the Taxpayer-Branded Products.

The IRS defined both a warranty obligation and an insurance contact. According to the IRS, although a warranty and a service contract have many of the same features, a manufacturer's warranty guarantees the integrity of a manufactured item, whereas an insurance contact reimburses a loss caused by an outside force such as a fire or accident. The IRS stated that in this case, Taxpayer contractually stepped into the shoes of the manufacturer when it sold its branded products.

The IRS distinguished a manufacturer's warranty from a separately priced extended warranty (which has been found to be "insurance" in a number of rulings issued by the IRS) by noting that an extended warranty protects the customer against failures that occur beyond the general merchantability period of the goods. Finally, the IRS concluded that any risk that Taxpayer would pay out more in repairs than the amount factored into the price of the product for repair cost is a business risk, and that the insertion of a third party does not create insurance for federal tax purposes. The manufacturer's original product warranty risks covered by reimbursement policies purchased by Taxpayer did not constitute insurable risks.

23 TAM 200827006.

09

Other

Introduction

Throughout 2008, the IRS scrutinized entities claiming exemption under Section 501(c)(15) and stressed the importance of reviewing qualifications on an annual basis, as determined by factors such as whether the entity's primary activity constituted insurance, whether both risk shifting and risk distribution were present, and whether the new gross receipts requirements under the Pension Funding Equity Act of 2004 (PEFA) transition rule were met. According to some of the notices issued in relation to PEFA, some companies did not properly comply with these changes. Moreover, insurance was not found to be a primary activity when revenues were mostly derived from investment income.

During the year, the IRS revoked exemption status of companies because policy contracts did not contain sufficient risk shifting and risk distribution, and accordingly the predominant activity was deemed not to be insurance, and that such income was attributable mainly to investment income. The IRS recommended retroactive revocation in cases of omissions and misstatements of material facts in the application process for exempt status under Section 501, or incorrect income reporting. The IRS ruled that companies that were in receivership but qualified for the transition rule under PEFA would not lose their exempt status.

Guidance was provided by the IRS on the exclusion of income that was derived from essential governmental function for purposes of Section 115(1) and the obligation of material advisors regarding reportable transactions under Section 6112. The IRS provided a list that exposed the 12 most flagrant tax schemes.

Section 501(c)(15)

Loss of exemption for failure to meet statutory requirements[1]

In separate but similar rulings, the IRS revoked each company's exemption status because they failed to meet the requirements of an insurance company as defined by Section 501(c)(15). Section 501(c)(15) generally recognizes certain insurance companies or associations other than life as exempt if the net written premium (or, if greater, the direct written premium) for the taxable year does not exceed $350,000 for years prior to January 1, 2004. For years after December 31, 2003, the law was amended to state that gross receipts can total $600,000 and premium income must be at least 50 percent of total gross receipts.

In TAM 200807018, ORG was formed as an insurance company and had previously received an exemption letter from the IRS. ORG stated that its insurance activities were to write policies covering third-party environmental liability on storage tanks leased to customers; automobile damage to automobiles resulting from car wash facilities and car wash equipment; tank damage covering damage resulting from Acts of God; and unintentional misuse, destruction, or mutilation. The IRS concluded that, because the insurance policies involved only one party, the policies lacked the requisite risk distribution to qualify as insurance.

1 TAM 200807018, PLRs 200803022, 200809034, 200842049, 200851026.

In PLR 200803022, ORG was formed as a captive insurance company to reinsure and insure the risks associated with the operations of its parent and affiliate bank. The IRS issued a determination letter granting ORG exempt status as an organization described in Section 501(c)(15). Due to reorganization, ORG received 88.6 percent of the gross income from interest and dividends and only earned 11.4 percent of its combined total revenue from insurance premiums, but did not inform the IRS of this change in business. The IRS determined that ORG should not be classified as an insurance company because its primary and predominant business activity during the relevant taxable years was its investment activity, not its insurance activity. The IRS also recommended retroactive revocation of the determination letter because there were omissions and misstatements of material fact during the application process and also a material change in operation.

In PLR 200809034, ORG indicated that its objectives were to carry on the business of insurance, captive insurance, and reinsurance; to act as agents and/or brokers for insurance companies and syndicates; and to accept risks, settle claims, solicit insurance business, and conduct all other related incidental matters. The IRS selected ORG's Form 990 for examination for year ending December 31, 20XX and determined that ORG's operations had changed since its exemption was granted.

In PLR 200842049, ORG was granted exempt status under Section 501(c)(15). The Form 990 filed by ORG for the year ended December 31, 20XX was examined to determine whether the organization continued to qualify under Section 501(c)(15). In response to an information document request, ORG stated that no carriers were participating in the program at the present time. The only income received and reported on Form 900 was investment income. No claims were filed or paid, no premiums were collected, and no reserves were maintained because there were no participants to file any claims. The only expenses incurred during both years included bank and administrative fees. ORG's only activity was to maintain investment accounts and receive investment income from those accounts. The IRS revoked the tax exemption status of ORG for the years beginning January 1, 20XX, the first year under examination, because ORG was not operating as an insurance company.

In PLR 200851026, ORG was formed in 19XX with the purpose of providing property and casualty insurance to area residents. During the year ending September 30, 20XX, 271 policies were issued, and at year end, 994 polices were outstanding with approximately $* * * of property and liability insured. ORG was not involved in any reinsurance contracts. No premiums were ceded during the year ending September 30, 20XX. ORG filed its Forms 990 on a September year-end and stated that it was tax exempt under Section 501(c)(6). IRS records showed that ORG was granted tax-exempt status under Section 501(c)(15). Form 990 was filed for the year ending September 30, 20XX. Upon review, the IRS concluded that ORG did not qualify for tax-exempt status for years beginning October 1, 20XX. Since ORG was not involved in a court-ordered liquidation for years beginning October 1, 20XX, Section 206(e) of the PEFA did not apply. ORG would not be entitled to relief under Section 831(b) for the year under examination or for future years until it filed the election. Future elections would be effective only for the year filed and for all subsequent years, not retroactively. Tax-exempt status was revoked for the years beginning October 1, 20XX. Since ORG was and continued to be a company, it was required to file its tax returns on a calendar-year basis.

Pension Equity Funding Act of 2004 (PEFA)[2]

The IRS issue a number of rulings that represent situations where the organizations lost exemption status under Section 501(c)(15) because they failed to meet new requirements for exemption under PEFA.[3] PEFA generally amended Section 501(c)(15) to provide for the exemption of insurance companies (as defined in Section 816(a)), other than life insurance companies (including interinsurers and reciprocal underwriters), if the gross receipts for the taxable year do not exceed $600,000 and more than 50 percent of such gross receipts consist of premiums.

In TAM 200809045, Company M was incorporated as a life and disability reinsurer and received an exemption letter recognizing it as exempt from federal income tax under Section 501(c)(15). According to the IRS, a review of Company M's activities for relevant years revealed that Company M was not issuing insurance or annuity contracts or reinsuring risks underwritten by insurance companies. Company M's premium income was de minimis compared to its investment income.

In PLR 200822040, ORG was granted exemption as a small insurance company described in Section 501(c)(15). Although ORG had been granted exemption under prior law, the IRS determined during the examination that ORG failed to meet the requirements for tax-exempt status because its gross receipts exceeded the dollar limitation imposed by the current law. As such, the IRS recommended that the organization's tax-exempt status under Section 501(c)(15) be revoked.

In PLR 200829053, ORG was formed for the purpose of insuring its members against loss by fire and lightning. The IRS conducted an examination of ORG's returns and concluded that ORG's operations during the relevant years did not qualify the organization for tax-exempt status. Even though ORG was able to meet the $600,000 gross receipt limitation, its premiums did not exceed 50 percent of the gross receipts. As a mutual company, ORG was able to meet the $150,000 gross receipt limitation, but its premiums did not exceed the 35 percent limitation required. The IRS recommended that the tax-exempt status be revoked and that the company be required to file Forms 1120/1120-PC for the relevant years.

In PLR 200830025, Taxpayer was a mutual property and casualty insurance company formed to provide fire and extended insurance for property owners. The IRS concluded that under current law, Taxpayer was no longer considered exempt since its premium income was less than 50 percent of total gross receipts. As such, Taxpayer was required to file Form 1120-PC for the relevant tax years and thereafter.

In PLR 200836038, ORG operated as a vehicle mechanical breakdown insurer. Though ORG had been previously granted an exemption, subsequent changes in law caused ORG to fail to continue to qualify for the exemption. Since ORG's gross receipts did not consist of adequate premiums to meet the gross-receipts test imposed under Section 501(c)(15), the IRS revoked its exempt status.

2 TAM 200809045; PLRs 200822040, 200829053, 200830025, 200836038, 200836043, 2008842052.
3 P.L. 108-218.

In PLR 200836043, ORG was formed for the purpose of providing a guarantee fund for self-insurers to protect workers and the families of workers employed by self-insurers who become insolvent. On its Form 990 returns, ORG reported income from gifts, grants and contributions, program service revenue membership dues/assessments, interest on savings, interest on restricted funds, premiums, and other income. According to the IRS, ORG failed to meet the requirements for tax-exempt status because its premium income did not meet the Section 501(c)(15) requirements. Although previously exempt, changes in the law led the IRS to recommend revoking ORG's tax-exempt status.

In PLR 200842052, ORG was formed to be operated as a mutual insurance company by its policyholders. The company applied for and received a ruling from the IRS for tax-exempt status under Section 501(c)(15) in August 19XX. Upon a review of ORG's operations, the IRS concluded that it had not operated in accordance with the provisions of Section 501(c)(15) and revoked the exemption effective January 1, 20XX. The IRS determined that ORG included certain depreciation and bank fees in investment income, which should have been reported separately as expenses on the Form 990 filed in 20XX. The IRS also determined that the total amount of commissions received from the reinsurer that ORG reported as other income on Form 990 should have been deducted from the total amount of reinsurance premium payments. As a result, the IRS concluded that ORG did not qualify for a Section 501(c)(15) exemption and revoked its prior ruling.

Application of PEFA transition rule[4]

In two similar rulings, the IRS held that an insolvent insurance company in receivership qualified for the transition rule under PEFA[5] for companies in receivership or liquidation. Generally, the special transition rule extends the effective date of PEFA from 2004 to 2007 for certain insurance companies in receivership or liquidation that otherwise qualify under Section 501(c)(15)(A).

In PLR 200810031, State Court placed Insurance Company in receivership due to its financial condition. As a result of the receivership, Insurance Company no longer met the definition of a life insurance company under Section 816(a). Pursuant to Insurance Company's Form 990 for the relevant dates, Insurance Company was in the midst of liquidation while still administering nonlife insurance claims, and did not have net or direct written premiums exceeding $350,000. The IRS concluded that Insurance Company was tax exempt under 501(c)(15) and satisfied the PEFA transition rule requirements. Based on the representations and information included in Insurance Company's submission, the IRS found that Insurance Company was "in a receivership, liquidation, or similar proceeding under the supervision of a State court" and, therefore, satisfied the PEFA transition rule requirements for companies in receivership or liquidation. Accordingly, Insurance Company continued to qualify as exempt during those years.

4 PLRs 200810031and 200831028.
5 *Id.*

In PLR 200831028, Taxpayer was also an insolvent insurance company being liquidated under the supervision of the court-appointed statutory receiver. On Date Z, Taxpayer was found to be insolvent and ordered into liquidation. All assets of Taxpayer were liquidated and creditor claims were paid, except for the final distribution of the remaining assets. The remaining assets were held until a determination that the final distribution would not cause federal tax liability under Section 501(c)(15). Upon examination, the IRS found that Taxpayer did not meet the 50 percent test under Section 501(a). The IRS determined that Taxpayer satisfied both requirements of the PEFA transition rule, and therefore the PEFA's amendments to Section 501(c)(15) did not apply to Taxpayer until tax years beginning after the earlier of the date the liquidation ended or December 31, 2007. Accordingly, Taxpayer continued to qualify as an exempt organization until the applicable date in the transitional rule.

Insolvent company not exempt[6]

In PLR 200824024, the IRS ruled that an insolvent corporation was not required to file as an insurance company exempt from federal income tax under Section 501(c)(15).

Taxpayer was a wholly owned subsidiary and was included in the consolidated group of Company A for relevant taxable years. A rehabilitation order was issued that placed Taxpayer in rehabilitation; Taxpayer was later found to be insolvent. Prior to the order, Taxpayer was admitted to sell workers' compensation, general liability, and other commercial insurance coverage in 49 states and the District of Columbia. Taxpayer never filed an application for recognition of exemption under Section 501(c)(15) or a return of an exempt organization claiming such status with the IRS, although it had no written premium income. Taxpayer requested a ruling from the IRS declaring that it was not required to file as an organization exempt from federal income tax as an insurance company other than a life insurance company under Section 501(c)(15) for the relevant taxable years and for subsequent taxable years.

In this instance, the IRS found that exemption from paying federal income tax was not required and there was no requirement that Taxpayer must be an exempt organization. In addition, since Taxpayer had never filed an Application for Recognition of Exemption as an insurance company exempt from income tax, or a Return of an Organization Exempt from Income Tax claiming the qualification, the IRS did not recognize Taxpayer as an organization exempt from taxation under Section 501(a).

While the ruling does not specifically state that an application must be filed to claim exempt status, it clearly suggests that exempt status is not automatic. In the case at hand, Taxpayer had not filed as an exempt company, and therefore made no such claim.

6 PLR 20084024.

Run-off activities are not exempt[7]

In the following rulings, the IRS found that two insurance companies in run-off did not qualify as tax-exempt insurance companies under Section 501(c)(15), because their primary activity was investing rather than insurance.

In TAM 200824028, Taxpayer assumed the assets, liabilities, and insurance business of Company P, a former member of Corporation C. Taxpayer filed a Form 1024 seeking tax-exempt status under Section 501(c)(15), which was granted. In its application, Taxpayer described its activities as writing business as a member of Corporation C. Taxpayer had been in run-off of the coverage originating from Corporation C. From its inception, Taxpayer's assets and surplus steadily grew, becoming extremely high. While assets and surplus were increasing, losses appear to have declined. The IRS concluded that Taxpayer did not qualify as an insurance company under Section 501(c)(15) since it had not operated in a manner consistent with the goals of a run-off business. Taxpayer's assets and surplus increased without a corresponding increase in proportion relative to its loss reserves. Although Taxpayer's expenses increased, this was largely attributed to bad debt/reinsurance loss. Management fees declined. Taxpayer did not undertake any efforts to expedite closing the run-off business or to develop additional business. The IRS also found that for certain tax years, the net written premiums exceeded the statutory limit for Taxpayer. The IRS also revoked the Section 953(d) election and denied relief pursuant to Section 7805(b).

In TAM 200824029, Company X was the successor of Company Z, which was an underwriting member of Corporation C. Company X filed a Form 1024 seeking exemption under Section 501(c)(15). From inception, Company X's potential liability for unpaid losses decreased. During that same period, Company X's assets increased. The amount of investment income in relevant years dwarfed the total amount of funds required or needed to resolve all potential insurance claims outstanding in each year. Company X had little premium income, significant retained earnings, and assets unrelated to insurance activities. Company X later purchased Company Q, resulting in Company X failing to meet the requirements of exemption under Section 501(c)(15) because Company X's aggregated premiums exceeded the statutory limit. The IRS concluded that Company X was not an insurance company because Company X's primary business activity for the years involved were investing its assets, not the business of insurance. In addition, the IRS stated that it would aggregate the premium income earned by Company X for the relevant periods, and Company X exceeded the statutory premium limitation set forth in Section 501(c)(15). The IRS also revoked the Section 953(d) election and denied relief pursuant to Section 7805(b).

7 TAMs 200824028 and 200824029.

Auction-rate securities

Settlement of potential legal claims[8]

In Rev. Proc. 2008-58, the IRS provided guidance on the treatment of taxpayers accepting certain settlements of potential legal claims relating to auction-rate securities. Shortly afterwards, the IRS corrected the revenue procedure to apply to the receipt of certain settlement offers in which the taxpayer does not have to release any claims as part of the settlement offer or does not have to accept the settlement offer to benefit from it.

For auction-rate securities, the payment rate is reset periodically according to an auction-rate-setting process. Rev. Proc. 2008-58 applies to taxpayers who, before June 30, 2009, receive settlement offers generally described in the revenue procedure that: (1) include "window periods" that do not extend beyond December 31, 2012; and (2) require that the taxpayer deliver an auction-rate security that the taxpayer purchased on or before February 13, 2008. Rev. Proc. 2008-58 does not apply to taxpayers who: (1) accept a settlement offer with respect to an auction-rate security; (2) make the election described in section 2.06 of the revenue procedure; and (3) take the position that they continue to own the auction-rate security following such acceptance and election.

For taxpayers within the scope of Rev. Proc. 2008-58, the IRS will not challenge the following positions:

- The taxpayer continues to own the auction-rate security upon receiving (or "opting into") the settlement offer.
- The taxpayer does not realize any income as a result of receiving (or "opting into") the settlement offer and does not reduce the basis of the auction-rate security from its original purchase price.
- The taxpayer's amount realized from the sale of the auction-rate security during the "window period" to the person offering the settlement is the full amount of the cash proceeds received from that person.

The corrected ruling eliminated the following paragraph from the scope:

> "However, this revenue procedure does not apply to taxpayers who (1) accept a Settlement Offer with respect to an auction rate security, (2) make the election described in section 2.06 of this revenue procedure, and (3) take the position that they continue to own the auction rate security following such acceptance and election."

8 Rev. Proc. 2008-58.

Section 165 final regulations[9]

The IRS issued final regulations on the availability and character of a loss deduction under Section 165 for losses sustained from abandoned stock or other securities. Under the final rules, a loss from an abandoned security is governed by Section 165(g) and allowed only if all rights in the security are permanently surrendered and relinquished for no consideration and applies to the abandonment of stock or other securities after March 12, 2008.

Any stock or other securities deemed worthless by a taxpayer should have adequate support to substantiate the claim and will always be considered to have occurred on the end of the taxpayer's year.

Section 115

Association's activities essentially governmental[10]

In PLR 200807001, the IRS ruled that upon termination of participation of any private or semiprivate entities of one association's benefit plan administered by another association, the income will be excludable from gross income under Section 115(1).

Under the facts of the ruling, Association is organized as a nonprofit corporation and comprises local subdivisions of the state and agencies of state subdivisions. Association distributed books, magazines, and other printed material; organized and conducted meetings, programs, conferences, and seminars; and proposed and advocated local, state, and federal policies pertaining to the use of water resources. With assistance from Association, its members formed Authority I, which provided risk-sharing pools to meet the needs of the members for property, liability, and workers' compensation coverage at a lower cost than commercial insurance. At the end of each coverage year, any excess funds and investment income were returned to Association's members, rather than retained as profit. Authority I's joint powers agreement provides that a water agency must be a member of Association to receive coverage through it.

Association also provided certain employee benefits to its members and certain nonmember water companies. The coverage was provided through Authority II which, like Authority I, was a state joint-powers authority. Authority II maintained an unfunded plan that held monies in custodial accounts. Upon termination of Authority II, any funds remaining in the accounts would be distributed to the entities that participated in Authority II's benefit plans for the 12 months preceding dissolution.

Section 115(1) provides that gross income does not include income (1) derived from the exercise of an essential governmental function and (2) accruing to a state or a political subdivision of a state. In Rev. Rul. 77-261, income from a fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its political subdivisions, is excludable from gross income under Section 115.

9 T.D. 9386.
10 PLR 200807001.

By helping local governments provide for the cost-effective acquisition, treatment, and distribution of water to the inhabitants of the state, Association performed an essential governmental function within the meaning of Section 115(1). Accordingly, the income of Association accrued to its members, all of which were states, political subdivisions of a state, or entities, the income of which was excludable from gross income under Section 115(1).

State insurance trust fund income and contributions excludable[11]

In three similar PLRs, the IRS ruled that the income from a trust created by a state agency to fund insurance benefits for retired state employees is excludable from the agency's gross income under Section 115 and that contributions to the trust will be excludable from the retiree's gross income under Section 106.

In PLRs 200815021 and 200815022, Trust, created by a Board acting as an instrumentality of the State, was established solely for the payment of healthcare benefits on behalf of eligible retirees, their spouses, and dependents. State provided initial funding for Trust, and additional contributions were made through various sources, including appropriations by the state legislature; contributions by employees and retired employees; employer contributions; investment income; proceeds of any gifts, grants, or contributions; and transfers from a state fund.

The IRS held that income of Trust was derived from the exercise of an essential governmental function and would accrue to a state or a political subdivision thereof for purposes of Section 115(1) and was therefore excludable from gross income. The IRS also held that the amounts paid to and from Trust were used solely to pay for health insurance premiums of retired employees and their spouses and dependents.

The IRS noted that the coverage provided under an accident and health plan to former employees and their spouses and dependents was excludable from gross income under Section 106, but only for the portion allocable to accident or health benefits.

In PLR 200830022, District was a unit of local government responsible for preventing pollution of City's source of water supply and treating wastewater to improve water quality in waterways within its jurisdiction. The act that organized District provided that the Board may establish one or more trusts to provide funding and payment of health and other fringe benefits for retired, disabled, or terminated employees of District. District established Trust to fund benefits under Plan, which provided for postretirement health benefits covering eligible retirees, their spouses, and dependents.

11 PLRs 200815021, 200815022, and 200830022.

The IRS concluded that the income of Trust is excludable from gross income under Section 115(1) because it was derived from the exercise of an essential governmental function. Trust provided health benefits to eligible retired District employees and their spouses and dependents. Providing health benefits to current and former employees constituted the performance of an essential government function. Based upon Rev. Rul. 90-74 and Rev. Rul. 77-261, Trust performed an essential governmental function within the meaning of Section 115(1).

The IRS concluded that contributions paid to Trust and payments made from Trust that were used exclusively to pay for the accident or health coverage were excludable from the gross income of retired employees and their spouses and dependents under Sections 105(b) and 106, and did not constitute "wages" under Section 3121(a)(2).

Life/nonlife AMT calculation

Adjusted current earnings calculation[12]

In *State Farm Mutual Automobile Insurance Co. v. Commissioner*, the Tax Court held that the common parent of an affiliated group that includes life and nonlife insurance companies must compute its adjusted current earnings (ACE) and ACE adjustment on a consolidated basis. For purposes of calculating the ACE and ACE adjustment, the court also held that the parent must use their preadjustment alternative minimum taxable income (AMTI).

Parent P was the common parent of a life-nonlife consolidated group from 1996 through 2002. When it made the alternative minimum tax (AMT) calculations for those years, Parent P originally calculated its ACE adjustment separately for its life and nonlife subgroups. The IRS issued Parent P a notice of deficiency for 1996 through 1999, and Parent P recalculated its AMT using a revised methodology that calculated ACE on a consolidated basis and did not apply the loss limitation rules of Section 1503(c) to preadjustment AMTI. Parent P's revised methodology reduced its ACE adjustment for 2001 and 2002, which caused a larger alternative tax net operating losses for its nonlife subgroup that was carried back to prior years. Parent P's methodology also decreased deficiencies and caused overpayments for 1997 through 1999.

While the court noted the issue was one of first impression, it stated the issue was analogous to previous litigation with State Farm regarding the calculation of its book income adjustment, which had since been repealed and replaced by the ACE adjustment.[13] In the prior litigation, the court agreed with State Farm that the book income adjustment should be calculated on a consolidated basis. In this case, the IRS argued that calculation of the ACE adjustment was a situation where the usual rules that apply to most consolidated groups (and that would require the ACE adjustment be calculated on a consolidated basis) do not apply to life-nonlife groups. "There is no reason to treat life-nonlife consolidated groups differently from other consolidated groups in the absence of an express directive in the Code or the regulations," the court wrote in disagreement. The

12 *State Farm Mutual Automobile Insurance Co. v. Commissioner*, 130 T.C. No. 16 (2008).
13 *State Farm Mutual Auto Insurance v. Commissioner,* 119 T.C. No. 21, 119 T.C. 342 (2002).

court held that a life-nonlife consolidated group is entitled to and must calculate its ACE adjustment on a consolidated basis. The court also agreed with Parent P's argument that the loss limitation rules applied to consolidated pre-adjustment AMTI under Reg. Section 1.56(g)-1(n)(3)(i). Accordingly, the court ruled that Parent P must apply the loss limitation rules to the AMTI when calculating consolidated ACE.

Retired agents

Right to renewal commissions[14]

In ILM 200813012, the IRS concluded that retired insurance agents' rights to renewal commissions under an insurance company's commission plan constituted nonqualified deferred compensation plans and that renewal commissions are subject to FICA tax when the commissions are paid to the retiree.

Company X's commission plan provided sales agents a commission upon the sale of an insurance policy and another commission if such policy was renewed. The renewal commissions extended to active or retired agents. Company X asserts that it could treat the renewal commissions that it may eventually pay a retired agent as subject to FICA tax on the retirement date of the agent.

Although the amount of renewal commissions was not reasonably ascertainable at the time of retirement, Company X relied on certain employment tax regulations that permit a taxpayer to take into account for FICA purposes an amount deferred under a nonaccount balance plan that is not reasonably ascertainable, provided that such amount is no longer subject to a substantial risk of forfeiture. For the years at issue, Company X apparently used the actual renewal commission payment data to retroactively determine the value of renewal commissions as of the date of the agent's retirement, rather than applying a methodology in order to estimate the fair market value on the date of retirement.

The IRS disagreed with this approach and denied Company X's refund claim for the FICA taxes. The IRS reasoned that if the policy was not renewed with the renewal premium paid, the renewal commission was forfeited. Accordingly, the renewal commissions were subject to a substantial risk of forfeiture at the time the agent retires.

14 ILM 200813042.

Reportable transactions

Material advisors requirement to maintain lists[15]

In Rev. Proc. 2008-20, the IRS provided guidance on the obligation of material advisors to prepare and maintain lists with respect to reportable transactions under Section 6112. The revised regulations were released in August 2007 and incorporate amendments to Section 6612 by the American Jobs Creation Act of 2004.[16] The revised regulations require material advisors to prepare and maintain separate lists for each reportable transaction for which a material advisor makes a tax statement on or after August 3, 2007 and for transactions of interest entered into on or after November 2, 2006.

Reg. Section 301.6112-1(b)(1) requires material advisors to maintain the information required in a form that enables the IRS to determine without undue delay or difficulty the information required in Reg. Section 301.6112-1(b). To be in a position to timely produce the required information, Rev. Proc. 2008-20 advises that the list should be maintained and updated on an ongoing basis. The revenue procedure also notes that the IRS may make targeted list requests for a list on a specific transaction in addition to general list requests that ask for all the lists the material advisor is required to maintain.

The material advisor may use, at his/her discretion, Form 13976, "Itemized Statement Component of Advisee List" (or successor form), for the purpose of preparing and maintaining the itemized statement component of the list with respect to a reportable transaction. Instructions for the use of the form also are available on the IRS website. Material advisors may use the form as a template for creating a similar form, including a spreadsheet, on a software program used by the material advisor. Material advisors are not required to use the form associated with this revenue procedure to comply with Section 6112. Material advisors who do not to use the new form or a similar method may find themselves at a distinct disadvantage, as Section 6708(a) provides for a penalty of $10,000 per day where material advisors fail to provide the IRS with requested lists within 20 days.

Top scams

The IRS announced in IR-2008-41 its 2008 list of the 12 most flagrant tax schemes that expose scam artists, taxpayers, and tax preparers to significant penalties, interest, and possible criminal prosecution. The "dirty dozen" included phishing, scams related to the economic stimulus payment, frivolous arguments, fuel tax credit scams, hiding income offshore, abusive retirement plans, zero wages, false claims for refund and requests for abatement, return preparer fraud, disguised corporate ownership, misuse of trusts, and abuse of charitable organizations and deductions.

15 Rev. Proc. 2008-20.
16 P.L 108-357.

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Multistate

State-by-state developments

Alabama

Proposed Regulation Chapter 482-1-44

This proposed regulation would replace the current rules in Chapter 482-1-095 to require mandatory filing of tax returns and payment of premium tax through the NAIC's OPTins system.

Arkansas

Attorney General Opinion 2008-089 (July 22, 2008)

According to the opinion, workers' compensation tax on written manual premiums is based on all premiums collected by the insurance carrier as of December 31 of the previous year, not on the initial premium collection. The tax is due annually on April 1. Any tax on additional premiums paid to carriers after December 31 of the preceding year must be collected in the subsequent year. The 3 percent workers' compensation tax on written manual premiums is collected at the same time and in the same manner as the insurance premium tax. The tax is assessed on "premium produced in a given year by the manual rates in effect during the experience period." The term "given year" refers to the calendar year, which means that premiums produced after December 31 are included in computing tax for the following year. Any additional assessment made during the current calendar year, but after the April 1 payment date would be based on premiums collected as of December 31 of the previous year.

Arizona

Arizona Industrial Commission v. Old Republic, Superior Court, Maricopa County, CV 2007-009031, November 7, 2008

The Superior Court ruled that the workers' compensation tax imposed by A.R.S. §23-961(J) should be applied to premiums net of large deductible reimbursements. The court held that the difference between the premium for a deductible policy and the premium for a first dollar policy is not a premium "collected or contracted for" and therefore not subject to the tax.

California

A 2143: Extends the sunset date to January 1, 2015 for the special assessment to fund the Fraud Division and Organized Automobile Fraud Activity Interdiction program. The special assessment requires every insurer doing business in California to pay an annual fee not to exceed $0.50 per vehicle insured under a policy. Effective 01/01/09. (Signed by governor 09/27/08.)

A 1088: Provides clarification that the risk finance portion of any blended finite risk contract used to finance state or federal Superfund clean-up settlements is not subject to the 3 percent California tax on a surplus line broker's gross premiums less return premiums from business done in the state under the authority of the surplus line broker's license. (Signed by governor 09/30/08.)

EDS, Cal. Bd. of Equalization, Hearing No. 361467, August 7, 2008

The California State Board of Equalization ruled that a California taxpayer was required to include its insurance company subsidiary, National Heritage Insurance Company (NHIC), in its unitary combined tax return. NHIC was neither licensed nor regulated as an insurer in California, and FTB Legal Ruling 385 (1975) did not apply because the insurer did not operate entirely outside California. The FTB filed a petition for rehearing, but later withdrew it.

Proposed REG-2007-00002

On March 25, 2008, California released for public comment a proposed regulation regarding reporting premium on a cash versus accrual basis. Written comments were due no later than April 10, 2008. The regulation would allow insurers to elect to report premiums on either a cash or accrual basis. Taxpayers would need to report on the elected method for the entire year unless involved in a merger. Once an insurer elects to report on a cash basis, it may not report on an accrual basis in subsequent years unless involved in a merger. Cash-basis taxpayers would be subject to additional reporting requirements.

Electronic Funds Transfer Penalty Regulations Adopted – REG 2330.1, 2330.3, 2330.4, and 2330.5

New regulations have been adopted that require insurers and surplus line brokers to make insurance gross premium tax payments by electronic funds transfer (EFT) if annual taxes exceed $20,000. Penalties will be assessed if payment is made by a method other than EFT or payment is not timely. Specific conditions for waiver of penalties and procedures for requesting a waiver are provided in the regulations.

Colorado

SB 60: Each insurer shall pay a biannual fee on January 1 and July 1 equal to $0.50 for every motor vehicle insured as of July 1 to support the Automobile Theft Prevention Authority. By August 15, the insurer is required to notify the Automobile Theft Prevention Program of the number of motor vehicles insured by that insurer as of July 1. (Signed by governor 06/30/08.)

Interest Relief Provision Adopted (September 23, 2008)

The Colorado Department of Revenue has announced that it will honor the penalty and interest relief provisions adopted by the IRS as a result of several 2008 hurricanes for all Colorado taxes that are administered by the Department. Taxpayers should simply write “Hurricane Ike” in red on the front of the tax return. Also, taxpayers that receive a bill or notice that they believe is incorrect based on these relief provisions, or that believe additional relief is warranted, should submit a written explanation as to why they believe a waiver of penalty and interest is appropriate and enclose a copy of the bill.

Connecticut

Payment Deadlines for Refunded Assessments Announcement 2008(2)

Members of the Connecticut Insurance Guaranty Association (CIGA) must pay a portion of the recently refunded assessments to the Department of Revenue Services (DRS) on or before February 11, 2008. CIGA had mailed to its members an assessment statement and refunded a portion of prior assessments that were made to meet CIGA’s obligations.

- CIGA assessments payable by a member insurer prior to January 1, 2000 are not permitted to offset the insurance premium’s tax liability and none of the refundable amount must be paid to the DRS.
- CIGA assessments payable by a member insurer on or after January 1, 2000 are permitted to be offset against the member’s Connecticut insurance premium tax liability, and the refundable amount shown on the statement from December 27, 2007 must all be paid to the DRS.

Corporate Income; Insurance Taxes; Tax Credits Guide Updated (July 9, 2008)

The Connecticut Department of Revenue Service’s publication has been updated. The publication lists and summarizes the tax credits currently available. It also identifies any applicable legislative or policy changes; explains the statutory ordering rules for an entity claiming multiple tax credits; and addresses reporting requirements for the Form CT-1120K, Business Tax Credit Summary.

Delaware

Notice of Change to Quarterly Estimated Tax Payments for the Insurance Premium Tax, (July 14, 2008)

Estimated payments for the insurance premium tax are changing from four equal installments to 50 percent of the current year's estimated tax by April 15, 20 percent by June 15, 20 percent by September 15, and 10 percent by December 15. Any remaining balance is to be paid by March 1 of the following year. This change will be reflected on the 2009 tax forms.

District of Columbia

Act 14-419 (Law 17-219): Provides for tax on captive insurers organized as a risk-retention group at the rate of 38/100 of 1 percent on the first $20 million of its total net direct premiums, 25/100 of 1 percent on the next $20 million of its total net direct premiums, and 18/100 of 1 percent on each additional dollar of its total net direct premiums. The tax is effective January 1, 2008. (08/16/08)

District of Columbia Act 17-419: Provides for tax on captive insurers organized as a risk-retention group at the rate of 38/100 of 1 percent on the first $20 million of its total net direct premiums, 25/100 of 1 percent on the next $20 million of its total net direct premiums, and 18/100 of 1 percent on each additional dollar of its total net direct premiums. This tax is effective January 1, 2008.

All health maintenance organizations must pay tax equal to 2 percent of their policy and membership fees and net premium receipts or consideration received in the calendar year, effective January 1, 2009.

Each calendar year, all companies that issue contracts of insurance against accident and loss of health must pay tax equal to 2 percent of their policy and membership fees and net premium receipts or consideration received in that calendar year on all policies or contracts. This tax is effective October 1, 2008.

Florida

Rule 12B-8.006 State Fire Marshal Regulatory Assessment and Surcharge

The amendments provide new percentages that will be used to compute the state fire marshal regulatory assessment, starting with the 2008 insurance premium tax return.

Rule 12B-8.0016 Premium Tax Database

The electronic Insurance Premium Tax Address/Jurisdiction Database will be maintained by the Florida Department of Revenue and used to assign insurance policies and premiums to local tax jurisdictions. A formal policy and procedure exists for change requests made by local tax jurisdictions and objections to tax jurisdiction assignments.

Effective March 17, 2008, insurance companies may register and create a user name and password to download address/jurisdiction database files for Florida insurance premium tax. The database is required to be used for calendar year 2009 to report premiums.

Legal Expense Insurers Filing Fees

Tax Information Publication 08(B)8-02

Effective for calendar year 2008 and for each year thereafter, the quarterly statement filing fee and the annual statement filing fee for legal expense insurers should be paid directly to the Office of Insurance Regulation, not to the Department of Revenue.

Project Income for Capital Investment Credit

Technical Assistance Advisement No. 08C1-001

Taxpayers must separately account for, using a "pro forma" format, the qualifying project's annual taxable income and subsequent tax credit.

Updated Database for Situsing Insurance Premiums Excise Taxes

Tax Information Publication No. 08B8-03 (April 25, 2008)

The updated insurance premiums tax address/jurisdiction database for Firefighter's and Police Officers' Pension Trust Funds Excise Taxes is available for download. This updated database is required to be used to report premiums for the 2009 calendar year and may be used to report 2008 premiums.

Georgia

H 977: Provides for a credit against the corporate income tax for qualified health insurance expenses, effective January 1, 2009. The credit is $250 for each employee enrolled for 12 consecutive months in a qualified health insurance plan, as long as such insurance is made available to all employees. Additionally, insurers are exempt from applicable state and local premium taxes on premiums paid by Georgia residents for high-deductible health plans sold or maintained in connection with a health savings account. (Signed by governor 05/07/08.)

Hawaii

***Hawaii Insurers Council v. Lingle*, No. 27840, Ha. Sup. Ct., December 18, 2008**

The Hawaii Supreme Court overturned a Hawaii Intermediate Court of Appeals decision, which held that payments to the state's Insurance Regulation Fund were determined to be an illegal tax instead of a permissible fee, because the taxing power cannot be delegated to the executive branch. The Intermediate Court of Appeals found that the assessment was a tax and not a fee based upon the following:

- The charge to insurers benefited the public, not the insurers.
- The assessment funds were transferred to the state's general fund and not allocated to services provided to insurers.
- The assessments were not reasonably proportionate to the benefits received by the insurers.

In overturning the decision, the Hawaii Supreme Court held that the assessments levied against insurers were not unconstitutional taxes because the funds were used for the regulation or benefit of the fee payers. However, the court did hold that the legislature's transfer of a portion of the funds into the state general funds violated the separation of powers doctrine.

Idaho

H 412: Changes the annual due date for filing the managed care organization annual report of financial condition with the director of the Department of Insurance from March 1 each year to June 1. Effective 07/01/08.

Illinois

Insurance Company Apportionment

Regulation 100.3420

Insurance companies are required to apportion income to Illinois by dividing direct premiums written for risks in Illinois over direct premiums written for risks everywhere.

"Direct premiums written" includes premiums, assessments, and annuity considerations; it does not include interest, dividends, gains or losses, deposit-type funds, or premiums exempt from state income tax by federal law.

Indiana

Rev. Rul. No. IT 08-01 (September 12, 2008)

The Department of Revenue ruled that the taxpayer, who solely offered Medicare Part D plans, was not subject to the Indiana gross premium tax because of a federal law (42 CFR § 423.440) that prohibits states from taxing premiums paid on behalf of Part D plan enrollees or beneficiaries. Since the taxpayer was not subject to the gross premium tax, the in-lieu-of provisions under IC 6-3-2-2.8 do not apply and the taxpayer is therefore subject to the Indiana corporate income tax.

Iowa

SF 2337: Provides that the payment of worker's compensation benefits under self-insured programs by the association of state fairs shall be exempt from taxation. The bill also provides that the association of county fairs shall be deemed a municipality for the purposes of joining a local government risk pool. Effective 07/01/08. (Signed by governor 05/07/08.)

Kentucky

HB 524: Creates a new section under Kentucky Revenue Statutes Chapter 91A addressing local government taxes and fees. For tax periods beginning after December 31, 2008, the statute of limitations for filing amended municipal returns, requesting refunds, and issuing assessments would be two years from the due date of the annual reconciliation. The legislation provides procedures, timelines, and administrative remedies for insurers and policyholders to request assistance from the Office of Insurance where a local government fails to accept an amended return or issue a refund. The bill also provides procedures and remedies to local governments where the local government has a reasonable basis to believe that a license fee or tax has not been paid or underpaid. Insurers that include local premium taxes as part of the policyholder premium charge would be required to separately state the amount of tax charged and the name of the taxing jurisdiction on the renewal certificate or billing. Insurers shall also notify each current policyholder before December 31, 2008 of the policyholder's rights under the new chapter. The bill would require the Office of Insurance to establish a risk location verification system, and on a biennial basis, insurers could be assessed a fee not to exceed $200 for the administration of the local premium tax provisions ($200 fee sunsets on July 1, 2010). Note that insurers or vendors can develop their own risk location verification system and pay a fee of $2,500 to the Office of Insurance to test the program and certify that it meets the criteria promulgated by the new chapter. (Signed by governor 04/14/08.)

HB 704: Provides that the gross premium tax surcharge used to fund the Firefighters Foundation Program fund and Law Enforcement Foundation Program fund does not apply to premiums collected from the federal government, Kentucky educational and charitable institutions that qualify for IRC Section 501(c)(3) status, Kentucky nonprofit religious institutions for property coverage, and state or local governments for real property coverage. The surcharge is equal to $1.50 per $100 of premium. (Signed by governor 04/24/08.)

Franklin County, Kentucky v. American International South Insurance Company; Franklin County, Kentucky v. Grange Mutual Casualty Company, No. 3: 08-43-DCR, October 29, 2008

Insureds have been denied, by a federal district court, the right to intervene in actions filed by a Kentucky county against insurers for the remission of tax imposed on insurance companies by local governments for the privilege of insuring risks within their geopolitical boundaries. The actions alleged that the insurers should have used the actual location of the risk versus the insureds' ZIP code since ZIP codes can occasionally cross geopolitical boundaries. The court held that the action sought to determine whether the insurers had remitted the proper amount of taxes.

Disclosure of Local Taxes in Premiums

Emergency Reg. 806 KAR 2:092E

In response to legislation (HB 524), the Kentucky Department of Insurance issued an emergency regulation in August providing required text for notification by insurers to current policyholders of their rights under HB 524 and to disclose local government taxes on renewal certificates or billings effective December 31, 2008. Once issued, the emergency regulation has the force of law in Kentucky. A nonemergency regulation was also issued, as the emergency regulation can be enforced for only 180 days.

Louisiana

Hurricane Recovery Benefits & Insurance Settlement, Rev. Rul. 08-001

Insurance settlement proceeds should not be deducted from individual and corporate state income tax. However, the hurricane recovery benefits should be included in income prior to the inclusion of the insurance settlement proceeds in the case that both were received by the taxpayer.

Maine

S 823: Requires each risk retention group to file on or before March 15 a return for the preceding year ending on December 31 with the state tax assessor and the superintendent of insurance. (Signed by governor 04/16/08.)

Maryland

Maryland S 444/ H 664: Corporations that are required to file a Maryland income tax return and are a member of a corporate group are required to file, on or before October 15, 2008, extensive information regarding pro forma combined income information reports with respect to the 2006 fiscal and 2007 calendar tax years. Taxpayers that fail to comply could be subject to penalties at the rate of $5,000 per day for the first 30 days and $10,000 per day thereafter, with no cap. On October 14, 2008 the state extended the deadline for filing the pro forma information reports to December 1, 2008. The definition of "corporate group" would exclude corporations that are not subject to federal income tax, insurers, and regulated investment companies. (Signed by governor 04/24/08.)

H 721: The sunset date of the Job Creation Tax Credit is extended from January 1, 2010 to January 1, 2014. The credit may be claimed only for qualified positions at newly established or expanded facilities whose operations started before January 1, 2013. Additionally, tax credits earned in credit years beginning before January 1, 2014 may be allowed ratably over a two-year period, may be carried forward, and are possibly subject to recapture. (Signed by governor 05/13/08.)

Massachusetts

Massachusetts H 4904: Effective for tax years beginning on or after January 1, 2009, Massachusetts mandates unitary combined reporting. Companies that are treated as insurance companies under I.R.C. Sec. 816 or I.R.C. Sec. 831 are excluded from the combined group. (Signed by governor 07/03/08.)

Michigan

S 1062: Provides an exemption from the Michigan gross direct premium tax for insurance companies authorized under Michigan law as captive insurance companies or special-purpose financial captives. (Signed by governor 03/13/08.)

H 5125: Insurance companies subject to the gross direct premiums tax may claim the Renaissance Zone credit effective January 1, 2008. (Signed by governor 12/27/07.)

H 5126: Insurance companies subject to the gross direct premiums tax may claim the Historic Preservation Credit effective January 1, 2008. (Signed by governor 12/27/07.)

Minnesota

Stewart Title Guaranty Company v. Commissioner of Revenue, Minnesota Supreme Court, No. A08-429, December 4, 2008

The Minnesota Supreme Court decided that the tax on title insurance premiums applies to the full amount of the premium charged by the insurance company and filed with the commissioner of commerce, including portions of the premium retained by agents. Affirming the decision of the Tax Court, the court held that, for the 2000 tax year, a plain reading of the statute clearly taxed gross premiums, which included the amount retained by agents. Furthermore, the amended statute was also found to tax the agent-retained portions of the premiums because it stated that the charge for title insurance was calculated according to the company's rate filing, as approved by the commissioner of commerce. The insurance premium in this case was listed in its rate filing as the full amount of the premium, including the portions retained by agents.

Mississippi

S 2563: The date by which insurance companies are required to file with the State Tax Commission the report of gross premiums and pay the taxes due for the period October 1 through December 31 is extended from February 20 to March 1. (Signed by governor 03/24/08.)

H 1662: Increases the amount of qualified community development entity credit to 8 percent. The credit may be claimed beginning in the year the investment is made and for two additional years. (Signed by governor 04/10/08.)

Missouri

American National v. Director of Revenue, Docket 05-1261, Missouri Administrative Hearing Commission, 12/27/2007

The Missouri Administrative Hearing Commission found that stop-loss coverage premiums and, more specifically, reinsurance premiums were "direct premiums." The court held that the Missouri premium tax was not preempted by the Federal Employee Retirement and Income Security Act (ERISA). Finally the court held that American National is not entitled to a refund for insurance premium tax paid on premiums received for stop-loss coverage for 2000, 2001, and 2002.

Letter Ruling 5192: The state issued a ruling determining that a taxpayer that is merely subject to the Missouri gross premium tax is not relieved from its Missouri corporate income tax liability. The applicant was exempt from the Missouri premium tax on its Medicare Part D premium under 42 CFR §423.330(b). The ruling further elaborated that the Missouri Department of Insurance, Financial Institutions, and Professional Registration administers the Missouri gross premiums tax, and that it is outside the scope of authority of the director of revenue to determine if the taxpayer was subject to the gross premiums tax.

New Hampshire

H 1378: Foreign insurance companies must pay a penalty of 10 percent of the amount of tax due for failure to file the annual report or to pay the gross premium tax by the January 31 due date. (Signed by governor 06/06/08.)

New Jersey

NJ Division of Taxation v. Selective Insurance, NJ Sup. Ct., App. Div., No. A-2402-06T3, March 28, 2008

The New Jersey Appellate Division of the Superior Court concluded that the 10-year statute of limitations for actions to collect unpaid taxes begins to run when the tax debt comes due, not when a surety declines to make a payment on a tax bond.

New York

SB 6807-C/ AB 9807-C: The New York Assembly approved an amended budget bill that would require a captive REIT or RIC to file combined corporate franchise, bank franchise, and insurance tax combined reports with its majority owners. (Signed by governor 04/23/08.)

Out-of-State Life Insurance Company Required to File

TSB-A-08(3)C

The state issued an advisory opinion stating that an out-of-state life insurance company domiciled in Texas that is not licensed to do an insurance business in the state of New York and has never generated any premiums allocable to New York will be considered a taxpayer subject to the New York insurance franchise tax and will be required to file annual returns. The insurance company invests in a limited partnership that invests in underlying hedge fund managers, many of whom operate in New York City. Income from the underlying hedge fund managers is allocated to the funds and ultimately the partners of the funds from the flow-through nature of the partnership investment.

Additional Guidance on Combined Reporting

TSB-M-08(2)C

The New York Department of Taxation and Finance clarifies that insurance companies subject to the franchise tax under Article 33 must file on a combined basis with related corporations where there are substantial intercorporate transactions.

North Carolina

Allocation of Premium Income

Directive CD-08-1

Gross premiums from individual and group policies that cover individuals living in North Carolina are taxable and should be allocated to North Carolina, regardless of the address of the policyholder, policy owner, or beneficiary.

Insurance Gross Premium Tax

2007-2008 Tax Technical Bulletin (G.S. 105-228.8)

Retaliatory gross premium tax for insurance companies that change domicile during the taxable year should be calculated by taking into account the portion of the year the company was domiciled in each state.

Oklahoma

Surplus Line Insurance

Attorney General Opinion No. 07-38

Surplus line insurance policies that are sold to the state of Oklahoma are subject to the 6 percent surplus line insurance tax. The only exemption to the surplus line tax is for sales of policies to federally recognized Indian tribes.

Oregon

Pacificare Health Systems, Inc. v. Department of Revenue, Or. Tax Ct. TC 4762, July 1, 2008

The Oregon Tax Court concluded that the licensee of intellectual property and not its insurance company subsidiary (the licensor) was the owner of the property for tax purposes, and therefore upheld the Department of Revenue's disallowance of the parent corporation's royalty expense deductions.

Wage and Commission Factor Excluded from Insurer Apportionment

OAR 150-317.660(2) (August 31, 2008)

For tax years beginning after 2006, the Oregon Department of Revenue updated its rule to exclude the wage and commission factor from the insurance gross premium tax apportionment factor.

Rhode Island

H 8067: A resident business acting as a surplus line broker may obtain a surplus line broker license by using the uniform business entity application. A licensee is required to file an annual report for business procured in the previous year by April 1. (Signed by governor 07/01/08.)

South Dakota

H 1200: Retaliatory tax will not be imposed on the portion of life insurance annual premiums exceeding $100,000. No retaliatory tax will be imposed on the annual consideration of an annuity contract exceeding $500,000. Effective beginning July 1, 2008. (Signed by governor 02/20/08.)

Metropolitan Life v. Kinsman, 2008 SD 24 (3/26/08)

The South Dakota Supreme Court ruled that South Dakota's taxing method did not unconstitutionally discriminate against out-of-state insurers by imposing a lower tax rate on businesses that maintain a principal or regional home office in South Dakota. The court concluded that the foreign insurer has the option of receiving the same favorable tax rate as a domestic insurer by opening a principal or regional home office in South Dakota and, therefore, it is a business decision that determines the ultimate tax rate, not discrimination.

Tennessee

Timely Filing of Premium Tax Returns

Proposed Rule 0780-1-50

Premium tax returns and payments will be considered on time if received in the department on or before March 1 and/or September 1 each year, or if the registered mailing date is no later than March 1 and/or September 1 and it was sent by United States mail with return receipt. If March 1 or September 1 falls on a holiday or a nonbusiness day, the due date will be considered the next business day.

Texas

First American Title Insurance v. Combs, Tex. Sup. Ct., No. 05-0541, May 16, 2008

Two out-of-state title companies doing business in Texas argued that the comptroller's interpretation of the retaliatory tax provisions resulted in artificially high retaliatory taxes and therefore violated the Equal Protection Clause of the US or Texas Constitution. The Texas Supreme Court affirmed the appellate court's decision that the retaliatory tax did not violate the Equal Protection Clause. The court determined that the method of calculation did not impose additional restrictions and the difference in treatment of foreign and domestic insurers was rationally related to a legitimate government purpose. The case has been appealed to the US Supreme Court.

Guidance for Indemnity Insurance

Tax Policy News, Vol. XVIII, Issue 1

Indemnity insurance premiums should be sourced to the state where the home office of the insured is located. Insurers licensed in Texas must allocate premiums according to Texas tax statutes, not National Association of Insurance Commissioners guidelines or Statutory Accounting Principles.

Guidance on Automobile Insurance

Tax Policy News, Vol. XVIII, Issue 3

Automobile insurance is taxed on a "written basis" and therefore insurers can deduct from gross written premiums only the "unearned" portion that applied to cancelled policies. Additionally, licensed insurers that write any form of motor vehicle insurance in Texas are subject to the assessment for the Automobile Burglary and Theft Prevention Authority, which is $1.00 per "motor vehicle year."

Tax on Independently Procured Insurance Due May 15

Tax Policy News, Vol. XVIII, Issue 4

Premium tax on independently procured insurance should be reported and paid by May 15 for insurance policies in the previous year. "Independently procured insurance" refers to insurance coverage provided by an insurer not authorized or licensed to sell insurance in Texas where all negotiations for the policy have occurred outside Texas. Form 25-103 should be used. If payment is not made timely the insurance will become unauthorized insurance and corresponding penalties will be assessed.

Assessment Due Date Reminder

Tax Policy News, Vol. XVIII, Issue 6

The Texas Comptroller's Office issued a reminder that all licensed property and casualty insurance companies must compute and pay the Automobile Burglary and Theft Prevention Authority by August 1 each year for policies delivered, issued, or renewed from January 1 to June 30.

Surplus Line Tax Responsibility

Tax Policy News, Vol. XVIII, Issue 7

The individual agent is responsible for the payment of tax when such individual has a surplus line license and sells surplus line policies under his/her name. If the agent leaves the agency, the surplus line business/policies belong to that particular agent unless an agent of record letter for each policy that is transferred exists.

Guidance for Licensed Insurers

Tax Policy News, Vol. XVII, Issue 12

Taxation of property and casualty insurance is on a "written basis" and the premiums must be allocated to each state to reflect the location of the risks in that state. The three categories of deductions from the property and casualty premium tax base are: premiums from another authorized insurer for reinsurance, returned premiums to a policyholder, and dividends paid to policyholders.

Assessment Recoupment Plan

The Texas Department of Insurance requested comments by March 15, 2008 on options being considered for an insurer to recoup all or any part of the Texas Windstorm Insurance Association assessment paid. These proposals provide authorization of a more rapid recovery of the assessments than solely through premium tax credits.

Volunteer File Department Assistance Fund Assessment

Proposed Rules, TRD 200800093

The comptroller of public accounts proposed an amendment to Texas Insurance Code §3.834. The amended rule sets out the formula for the calculation of the assessment, clarifies the final assessment date, deletes the definition of assessment date, and stipulates that insurers may recoup the assessment from policyholders. The amendment includes changes to statutory citations based on the recodification of the insurance code.

Utah

H 466: Licensed title insurance agencies are required to pay an annual assessment not to exceed $1,000 to finance the Title Insurance Recovery, Education, and Research Fund, effective January 1, 2009. Additionally, effective January 1, 2009, an individual applying for a license or renewal of a license as a title insurance producer must pay an assessment not to exceed $20. (Signed by governor 03/17/08.)

Vermont

Housing Investment Tax Credit

Vt. Dept. of Housing and Community Affairs, Housing Division Rules, Part IV

Effective January 1, 2008, a credit may be claimed against premium tax for an approved charitable investment in an eligible housing charity. The credit is the difference between the net income that would have been received by the taxpayer at the charitable threshold and the actual net income received by or credited to the taxpayer.

Virgina

Rulings of the Tax Commissioner, Document No. 08-191 (December 1, 2008)

The Virginia Tax Commissioner ruled that the determination of whether a corporation is subject to the license tax on insurance premiums rests with the Virginia Bureau of Insurance. Furthermore, the tax commissioner determined that if the corporation was not subject to the premium tax, its income would be subject to the Virginia corporate income tax. The corporation is in the business of providing and administering prescription drug programs under the Medicare Part D program.

Washington

Laura Holden v. Farmer's Insurance Company of Washington, Wash. Ct. of App., No. 59024-3-I, January 22, 2008

The Washington Court of Appeals held that insurance coverage of actual cash value of a property loss indemnifies the insured only against actual loss. Actual cash value does not cover sales tax unless the insured actually replaces the property, therefore incurring the sales tax.

Skagit County Public Hospital No. 1, d/b/a Affiliated Health Services, Appellant, v. State of Washington Department of Revenue, Respondent., 07-048 to 07-051, October 1, 2008

The Board of Tax Appeals sustained the Department's Final Determination No. 07-0046. The hospital is required to pay tax on its receipt of Medicare copayments (Medicare deductibles and coinsurance) received from patients and their insurers. The hospital must pay all interest included in the department's initial assessments and all interest accrued after the due dates set forth in the initial assessments.

West Virginia

S 680: The governor of West Virginia signed into law a bill that modifies the application of the state's combined reporting regime. Insurance companies are now exempted from participating in a combined report unless specifically required to so by the tax commissioner, beginning on or after January 1, 2009. (Signed by governor 03/31/08.)

Wisconsin

S 386: Effective April 9, 2008, any action to recover a premium tax or designated insurance fees must be brought in the Dane County circuit court within six months from the time the tax or fee was paid. (Signed by governor 03/26/08.)

Retaliatory Notice to California and Washington Domestics

The Wisconsin Insurance Department has notified domestic insurers in California and in Washington that Wisconsin considers the California fraud assessment and the Washington regulatory surcharge to be subject to retaliation under Wisconsin's retaliatory tax law.

11

Tax accounting

Introduction

US companies first complied with Financial Accounting Standards Board (FASB) Interpretation Number 48, Accounting for Uncertainty in Income Taxes (FIN 48), requiring corporate financial statements to reflect the expected future tax consequences of uncertain tax positions. The adoption of FIN 48 led companies to increase total tax reserves by $1.3 billion, to $155.2 billion.[1] According to a report released in 2008, 280 companies increased their tax reserves by $8.1 billion, with a median increase of $7.5 million; and 151 companies decreased their tax reserves by $6.8 billion, with a median decrease of $7 million.[2]

At the National Association of Insurance Commissioners (NAIC) 2008 Winter National Meeting, working group discussions included a proposal by American Council of Life Insurers (ACLI) that statutory accounting requirements with respect to the recognition of deferred tax assets be changed to follow GAAP.[3] Other changes that might affect the insurance industry are FASB-related guidance on fair value accounting and trends such as the emergence of narrative reporting.

FIN 48

FASB votes to defer FIN 48

The FASB voted to grant a one-year deferral to all private entities, regardless of whether they are pass-through entities, in applying accounting for uncertainty in income taxes. This deferral was in addition to the deferral granted at the end of 2007. The decision resulted from the FASB's vibrant discussion on the scope of a proposed deferral on FIN 48 for certain private enterprises and defining pass-through entities for purposes of a deferral. The most common questions asked were (1) how would the deferral apply if a taxable entity has pass-through subsidiaries; (2) how would the deferral apply if a pass-through entity has taxable subsidiaries; and (3) how would a deferral affect an entity that is a pass-through for federal purposes, but is a taxable entity with uncertain tax positions for state, local, or foreign jurisdictions.

Perhaps lacking ready responses to the questions, the board decided to issue a proposed FASB Staff Position (FSP) to defer the interpretation for all nonpublic entities until fiscal years beginning after December 15, 2008, rather than limiting the deferral to pass-through entities only. FASB said it would work expeditiously to develop guidance relating to the applicability to pass-through entities, as well as modify the disclosure requirements for private entities and expose the guidance for comment as quickly as possible. The FASB suggested the FSP provide a principles-based approach to whether an entity is a pass-through entity, which it said should be defined as one where its owners pay the tax on the entity's income regardless of whether the entity makes a distribution of its income.

1 Stephan Joyce, *28 Percent of Firms Subject to FIN 48 Failed to Comply With Rules, Study Says, BNA* DAILY TAX REPORT, July 22, 2008.
2 *Id.*
3 NAIC Meeting Notes, Global Insurance Industry Group, Americas, NAIC Winter 2008 National Meeting – Special Edition (December 8, 2008) (on file with author).

On December 30, 2008, the FASB issued a final FSP to continue deferring the effective date of FIN 48 for certain nonpublic enterprises.[4] However, nonpublic consolidated entities of public enterprises that apply US GAAP are not eligible for the deferral. Likewise, according to the FSP, nonpublic enterprises that have applied the recognition, measurement, and disclosure provisions of FIN 48 in a full set of annual financial statements issued prior to the issuance of this FSP also are not eligible for the deferral. The deferred effective date is intended to give the board additional time to develop guidance on the application of FIN 48 by pass-through entities and not-for-profit organizations.

Study suggests that 28 percent of firms subject to FIN 48 failed to comply[5]

About 28 percent of firms subject to a new FASB rule did not "satisfactorily" comply with the standard, a July 21 report concluded. The report, published by New York-based Seigel & Associates LLC, analyzed the calendar 2007 financial statements of the 601 publicly traded firms reporting more than $2 billion in revenue and concluded, in part, that 169 of the firms did not satisfactorily comply with the FASB standard. Two significant areas of noncompliance were a lack of forward-looking statements about future tax positions and an absence of data, Seigel & Associates President J. Brad McGee told BNA on July 21.

A significant percentage of the tax reserves were accounted for by relatively few companies—about 50 percent of the tax reserves were accounted for by 4 percent of surveyed companies, McGee said. Adoption of FIN 48 also led 434 companies to reduce shareholder equity by $1.8 billion, the report said.

Capital surplus

NAIC considers change to tax asset admissibility

On December 17, 2008, the National Association of Insurance Commissioners (NAIC) requested comments regarding exposure drafts of the Capital and Surplus Working Group's (CSWG) consideration of the American Council of Life Insurers (ACLI) proposal for capital and surplus relief for life insurance companies. One such CSWG recommendation would increase the statutory admissibility limit on deferred tax assets (DTAs) from 10 percent to 15 percent of capital and surplus and expand the realization period from 1 year to 3 years.[6]

On January 2, the NAIC's Executive Committee held a conference call to discuss the CSWG's recommendations. According to NAIC President Roger Sevigny, because of the need to thoroughly consider the recommendation, "careful deliberation will be exercised before any action is taken."[7]

4 FASB, No. FIN 48-3: *Effective Date of FASB Interpretation No. 48 for Certain Non-public Enterprises, available at* http://www.fasb.org/pdf/fsp_fin48-3.pdf (last visited January 17, 2009).

5 Siegel & Associates LLC, *Nearly One-Third of Major Public Companies Fail to Fully Comply with Key Tax Reserve Disclosure Requirements*, SCIENCE LETTER, October 28, 2008.

6 NAIC, *Capital and Surplus Relief (EX) Working Group* Executive (EX) Committee Report, available at www.naic.org/committees_ex_capital_surplus_relief.htm (last visited January 18, 2009).

7 Press Release, NAIC Responds to Economic Difficulties, National Association of Insurance Commissioners (January 2, 2009) (on file with author).

The NAIC held a public hearing on the proposal on January 27, 2009. A During the hearing, Washington, D.C. Insurance Commissioner Thomas Hampton, who chairs the CSWG, defended the recommendations as “ensur[ing] that our basic regulatory objectives of financial solvency, conservative accounting standards and strong consumer protections continue to be met.”

On January 29, the NAIC rejected several of proposals that could have provided insurance companies with significant capital and surplus relief in response to the economic crisis. Justifying the action, NAIC President and New Hampshire Insurance Commissioner Roger Sevigny commented, “so far the insurance industry is in much better condition than most of the rest of the financial services sector because of strong state solvency regulations.”

Any future consideration of changes to regulatory requirements will follow the NAIC’s “open, transparent and deliberative process,” according to NAIC Vice President and Iowa Insurance Commissioner Susan Voss.

Tax accrual workpapers

To argue against taxing authorities’ attempt to gain access to tax accrual workpapers, taxpayers have asserted the attorney-client privilege, work product doctrine, and the tax practitioner privilege. Determining which, if any, of these “protections” apply, has become the source of frequent litigation.

Since the Textron[8] decision, the IRS has not shied away from requesting tax accrual workpapers. In May 2008, the US District Court for the Northern District of Alabama granted a motion to deny an IRS summons served on an independent auditor because it found that the client’s tax accrual workpapers were protected by the work product doctrine. Meanwhile, in August the US District Court for the Northern District of Illinois found the tax practitioner privilege does not apply to certain documents or otherwise protected communication made in connection with the promotion of tax shelters.[9]

Work product doctrine[10]

In *Regions Financial Corp. v. United States*, the US District Court for the Northern District of Alabama granted a motion by Regions Financial Corporation (Regions) to quash an IRS summons served on Regions’ independent auditor, seeking Regions’ tax accrual workpapers. The court found that the documents were protected by the work product doctrine, as they were created in anticipation of litigation and Regions had not waived its privilege when it disclosed the documents to the auditors.

8 *US v. Textron, Inc. and Subsidiaries*, 507 F.Supp.2d 138 (D. R.I, 2007).
9 *Valero Energy Corp. v. US* 2007 WL 4179464 (N.D.Ill. 2007).
10 *Regions Financial Corp. v. US*, No. 2:06-cv-RDP-00895 (N.D. Ala. May 8, 2008).

In 2000, Regions entered into a transaction with the European Bank for Reconstruction and Development (EBRD). During an IRS exam for the 2002 and 2003 tax years, the IRS determined that Regions had engaged in two listed transactions. The IRS served a summons on the auditors, who provided the summons to Regions. After reviewing the summons, Regions permitted the auditors to produce approximately 260,000 pages of documents, but instructed that 20 documents totaling 151 pages relating to the EBRD transaction be withheld. Thereafter, Regions filed a motion to quash the summons with the court, claiming that the documents were privileged and therefore not subject to the IRS summons.

The court noted that Regions did not contest that the IRS summons was proper on its face, but rather claimed that the documents being withheld were subject to the work product doctrine or privilege. As a result, the court determined the heart of the dispute was the scope of the work product doctrine as applied to the documents and whether Regions had waived any privilege by the disclosure of the documents to the auditors. Acknowledging that the Supreme Court has not provided controlling guidance on this matter, the court addressed the two prevailing standards: the "primary motivating purpose" standard first articulated in *US v. El Paso Co.* 682 F. 2d 530 (5th Cir. 1982), Cert. denied, 466 U.S. 94 (1984) and the "because of litigation" standard first articulated in *US v. Adlman* 134 F. 3d 1194 (2nd Cir. 1998). The court noted that the "because of litigation" standard afforded broader protection.

As the parties disagreed over which standard should apply, the court reviewed the relevant case law with respect to precedent and concluded that the "because of litigation" standard should be applied to the case at issue, but noted that the same result occurs under either standard. Citing *Textron*, the court found persuasive Regions' argument that Regions would not have the contingent liability that the documents address if it did not believe that it would engage in litigation with the IRS over the tax consequences of the transaction. Rejecting the government claim that no work product privilege exists if the document had any other use other than litigation, the court noted that it had not found support for the proposition that the exclusive use of the document must be for litigation. After reviewing the documents, the court found the disputed documents contained the mental impressions of Regions' lawyers, which it noted is precisely the kind of legal analysis that the work product doctrine seeks to protect. As a result, the court concluded that Regions carried its burden of showing that the documents were created in anticipation of litigation.

The government argued that the disclosure to the auditors constituted a waiver. The court rejected this argument, stating that the auditors was not an adversary of Regions and, based on a confidentiality agreement wherein the auditors agreed to protected documents provided by Regions, the auditors was not a conduit to an adversary. The court quashed the summons because it found that the disputed documents were privileged and that the privilege had not been waived.

The court's opinion indicated that whether documents are subject to the work product doctrine was a fact-and-circumstances test and that in this particular situation, the taxpayer's facts supported a finding that the disputed documents were protected by such doctrine. Although this was the second loss for the government at the district court level on access to tax accrual workpapers, the IRS publicly stated that it continues to believe that the work product doctrine is not an appropriate defense to a request for tax accrual workpapers.

On December 22, 2008, Regions and the IRS announced a settlement agreement that established Regions federal tax liabilities through 2006.[11] Although no details were provided, the announcement provides that the settlement includes matters related to Regions' real estate investment structures and covers Regions' tax returns for tax years 1999 through 2006. However, the agreement does not provide that the tax workpapers issue was part of the settlement.

Tax practitioner privilege[12]

In a decision regarding Valero Energy Corp.'s claims that documents sought by the IRS as part of a tax shelter investigation are privileged, the US District Court for the Northern District of Illinois found the tax practitioner privilege did not apply to certain documents, including non-US tax advice, business or accounting advice, engagement letters, and billing sheets. In addition, the court found that the privilege did not apply to protect communication made "in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter."

Valero acquired a Canadian refinery after a 2001 merger with Ultamar Diamond Shamrock. In November 2006, the IRS issued an administrative summons to Valero and Arthur Andersen LLP (Andersen), Valero's tax advisors, seeking to examine the books, papers, and other records relating to the federal tax liability of Valero and its subsidiaries for calendar years 2002 and 2003. Valero moved to quash the IRS summons. In January 2007, the IRS issued a second summons to clarify the first. The IRS investigation focused on Valero's potential income tax liability for possible use of potentially abusive tax shelters, which included the Canadian refinery.

In an August 2007 proceeding, Valero contested the IRS summons on the grounds that it was vague, overly broad, and sought documents subject to either the work product doctrine or the tax practitioner privilege. The court rejected Valero's claims of protection under the work product doctrine, finding that Valero failed to show the documents were created in anticipation of litigation. Therefore, the court ordered Valero to produce documents denoted as privileged under the work product doctrine, but granted Valero's motion to quash as to the documents for which Valero claimed the tax practitioner privilege. The court rejected the government's claim that the tax shelter exception applied, finding that Valero's dealings with Andersen had nothing to do with "promotion" of participation in a tax shelter.

After Valero informed the court that it located 20 additional boxes of potentially responsive documents, the government filed a new motion seeking production of certain documents Valero withheld or partially redacted based on a claim that their content was covered by the tax practitioner privilege. Some of these documents included Canadian tax advice Valero received from Andersen.

11 Press Release, Regions Reaches Agreement with IRS, Regions Financial Corporation (December 24, 2008) (on file with author).
12 *Valero Energy Corp*, 2007 WL 4179464 (N.D.Ill. 2007).

The government contended that because a tax practitioner cannot practice Canadian tax law before the IRS, the statutory privilege under Section 7525 did not apply to Canadian tax advice. Valero responded that it found references to Canadian taxes in only five documents it claimed to be privileged, and argued that it properly withheld those five documents because they contain pervasive references to privileged United States tax matters and could not be produced in redacted form. After examining the documents, the court held that communications pertaining to Canadian tax advice are not privileged under Section 7525. In addition, the court held that the tax practitioner privilege does not apply to engagement letters, billing sheets, business advice, or accounting services. On the bright side, the court held that the tax practitioner privilege and the tax shelter exception apply (or do not apply) on a document-by-document basis.

Under the tax shelter exception, the tax practitioner privilege does not apply to "any written communication between a federally authorized tax practitioner and a director, shareholder, officer, or employee, agent, or representative of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter." In turn, Section 6662(d)(2)(C)(ii) defines a tax shelter as "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax."

The court ruled that based on the totality of the circumstances, the government met its burden of showing that the transactions involved a tax shelter. In particular, the court agreed that Andersen was involved in formulating a circular, intracompany step plan for Valero and Diamond Shamrock to generate foreign exchange losses in 2002, with a significant purpose of avoiding US income tax. While Valero argued the transactions at issue had legitimate business purposes, the court held that it failed to explain how or why tax avoidance was not a significant purpose of the transactions. As a result, the court ruled that tax avoidance was a significant purpose of Valero's transaction and ordered production of most of the disputed documents pursuant to the tax shelter exception to the tax practitioner privilege.

In December, Valero filed its appeal in the Seventh Circuit Court of Appeals, arguing that the district court erred in applying the tax shelter promotion exception to the tax practitioner privilege to enforce the summons on Valero's tax advisors.[13]

IFRS

SEC offers potential path for adopting IAS[14]

The SEC unanimously proposed a roadmap that could lead to a mandatory phased conversion to IFRS for US companies beginning as early as 2014 if a series of "milestones" are met. The proposal could allow the largest 20 US companies by market capitalization in their worldwide industries that already predominantly use IFRS globally to voluntarily file under international standards in the United States. The companies also would have to use IFRS as approved by the IASB.

13 Appellant's Opening Brief, *Valero Energy Corp. v. United States*; No. 08-3473 (7th Cir. 2008).
14 Steven Marcy, *SEC Offers Potential Path for Adoption of International Accounting Standards*, BNA DAILY TAX REPORT, August 28, 2008.

Potential early adopters of IFRS identified so far by the IRS numbered at least 110 US multinational companies operating in over 34 industries, SEC staff said at the August 27 meeting.

"To be eligible for early adoption of IFRS in the United States, companies would have to demonstrate that adoption of the standards would improve investors' ability to compare them with other companies in their respective industries and that they already used IFRS predominantly in filing financial reports around the world," SEC Director of the Division of Corporation Finance John White said. Under the current proposal, the SEC envisions large public companies that file financial reports on an accelerated basis to begin using IFRS in 2014, while medium-sized, accelerated filers may be in 2015, and small, nonaccelerated filers in 2016.

Early adoption will not come cheaply; the SEC has estimated that the transition will cost each early adopter $32 million over the first three years of filing form 10-K under IFRS. At least one corporate controller is on record as saying his company does not see an advantage to being a first mover. Nick Cyprus, controller and chief accounting officer at General Motors, believes there needs to be more convergence before conversion and that "… there's no first-mover advantage here."[15]

FASB and the IASB issued an updated memorandum of understanding (MOU) titled "Update to 2006 Memorandum of Understanding," on September 11, 2008, stating that joint projects on major standard-setting initiatives were expected to be completed by 2011.[16] Commenting on the MOU at a meeting of world financial accounting standards setters in London, FASB Chairman Robert Herz said the SEC, when determining whether to mandate adoption of IFRS by US firms, would consider progress on the joint projects' efforts. The 2011 date for completion of the MOU coincides with the SEC's plan to revisit its proposed milestones, at which point it will determine whether to mandate US firms to adopt IFRS beginning in 2014, with subsequent waves in 2015 and 2016.

Eligible companies that elect to early adopt IFRS in the United States will want to know more precisely what the SEC will require for reconciliation of IFRS to US GAAP. The discussion in the SEC's meeting before its unanimous vote to issue a roadmap for possible mandatory adoption of IFRS made it clear that reconciliation will be required for 2007, 2008, and 2009, but the key question going forward is how many years of reconciliation the SEC will require. The other concern is exactly how the test for early adoption will work.[17]

IFRS may affect US insurance companies

While US insurers may not yet implement IFRS No. 4, Insurance Contracts, they are encouraged to learn about the new provisions; which could affect the perception of business operations; change the range of products offered; improve asset-liability management by implementing the current exit value method; improve risk management procedures due to greater accountability and availability of information; and leverage mergers and acquisitions as a tool to improve core competencies and quality.[18]

15 Marine Cole, *No gain from moving to IFRS early, says GM's controller*, FINANCIAL WEEK, November 18, 2008.

16 Denise Lugo; Stephen Bouvier, *Standard Setters Issue 2008 MOU, Link Completion Date to IFRS Adoption Decision*, BNA DAILY TAX REPORT , September 12, 2008.

17 Steve Marcy, Auditors, *Preparers Want More Information on SEC IFRS Reconciliation Requirements*, BNA DAILY TAX REPORT, September 8, 2008.

18 Stephanie Hench, *Adoption of IFRS Will Affect U.S. Insurance Industry, Deloitte Report Says*, 35 INS. TAX REV. 589, 590 (2008).

Using IFRS during the current financial crisis

The International Financial Reporting Standards "worked well" in accounting for assets and liabilities during the current credit crisis, based on information presented at an SEC roundtable in August, SEC Chairman Christopher Cox said after the session.[19]

Cox said that comments from roundtable participants indicated that IFRS "did a better job of keeping [special purpose entities (SPEs)] on the balance sheet" than did US GAAP. Off-loading subprime mortgages, packaged with higher-rated assets as securities into SPEs, was identified as one of the primary mechanisms for over-heating the US mortgage market and its subsequent collapse. Roundtable participants must also be subject to uniform applicability guidance and understand that there are fair value measurement and presentation challenges for both IFRS and US GAAP.[20]

FAS 157

Fair value accounting[21]

Statements of Financial Accounting Standards (SFAS) 157 clarified that the fair value estimate was intended to convey to investors the value of an asset or liability at the measurement date (a current value), not the potential value of the asset or liability at some future date (e.g., the amount a reporting entity expects to realize on settlement or maturity). For an asset, the fair value estimate is determined by reference to the price that would be received in an orderly transaction for the asset at the measurement date (an exchange price notion).

SFAS 157 established a fair value hierarchy prioritizing the inputs that should be used to develop the fair value estimate. In all levels of the fair value hierarchy, the objective remains the same—a current exchange price for the asset or liability. According to the FASB, fair value is the preferred method of many investors reviewing the value of financial assets because it is grounded in economic reality and facilitates informed investment decisions, ultimately strengthening our capital markets.

On October 10, 2008, the FASB issued fast-track staff guidance to clarify how to assign fair values to the kinds of troubled financial assets that figure in the current financial crisis.[22] Highly anticipated by banks and other financial companies, the FSP FAS 157-3 on determining fair value of a financial asset when its market is not active was issued hours after the FASB voted unanimously to publish the final guidance.

FASB Chairman Robert Herz said that the guidance does not represent a loosening of the fair value measurements standard. In comments at the meeting, the FASB's chairman also discussed the staff guidance to the Troubled Asset Relief Program (TARP).

19 *Id.*
20 *Id.*
21 Robert Herz; Linda MacDonald, Understanding the Issues: Some Facts about Fair Value, Financial Accounting Standards Board, May 7, 2008.
22 *FASB Issues Final Guidance on Fair Value of Financial Assets in Inactive Markets*, BNA DAILY TAX REPORT, October 14, 2008.

Herz suggested that, for him, the intersection of TARP and guidance on fair value measures for financial assets in inactive markets raised "a lot of questions that need to be thought about." The staff position was effective on issuance and will be applied to third-quarter reports. "Prior periods for financial statements that have not been issued would comply with the guidance in the final FSP," according to a FASB summary of decisions reached at an October 10 meeting.[23]

SEC advisory panel members back restatements only for material errors[24]

The SEC's Advisory Committee on Improvements to Financial Reporting indicated at a March meeting in San Francisco that it will continue to pursue a recommendation to ensure that financial restatements are restated only when a material error has occurred.

However, its members also backed its conclusion that all errors should be corrected and disclosed in the next reporting period after an error has been discovered. The recommendation stems from growing evidence that some companies are restating financial reports for trivial reasons that have no bearing on their true financial situation, which can drive up costs and provide no useful information to investors. The recommendations said the SEC should issue guidance on error corrections that should require restatements only for errors that are "material to prior [reporting] periods" and that the decision to issue a restatement should be based "on the needs of current investors."

23 *Id.*
24 Steven Marcy *SEC Advisory Panel Members Back Restatements Only for Material Errors*, BNA DAILY TAX REPORT, March 17, 2008.

Appendices

Appendix A

Cases

Insurancewide.com Services Ltd. v. Revenue & Customs,

2007 UKVAT V20394

The UK VAT Tribunal ruled that none of the insurance intermediary services provided by an Internet comparison website, fell within the UK VAT exemption because Insurancewide was not an insurance agent. Insurancewide specifically disclaimed being an agent on its website and was found to be playing no part in the negotiation of the contracts. Neither did Insurancewide have the power to bind the insurance company, which the tribunal found to be one of the indicators of an agency relationship (although not in itself determinative for VAT purposes). Her Majesty's Revenue & Customs (HMRC) department states that in circumstances where the provider is clearly acting as an agent of an insurer or insurers and is playing a more active role in arranging the policies than mere introduction, VAT exemption continues to apply.

Regions Financial Corp. et al. v. United States

No. 2:06-cv-00895 (N.D. Ala. May 8, 2008)

The US District Court for the Northern District of Alabama granted a motion by Regions Financial Corporation (Regions) to quash an IRS summons served on Regions' independent auditor, Ernst & Young (E&Y), seeking Regions' tax accrual workpapers. The court found that the documents were protected by the work product doctrine, as they had been created in anticipation of litigation and that Regions had not waived its privilege when it disclosed the documents to E&Y.

State Farm Mutual Automobile Insurance Co. v. Commissioner

130 T.C. No. 16 (2008)

The Tax Court ruled that the common parent of an affiliated group that includes life and non-life-insurance companies must compute its adjusted current earnings (ACE) and ACE adjustment on a consolidated basis and that it must use preadjustment alternative minimum taxable income to calculate its ACE and ACE adjustment.

Fisher v. United States

102 AFTR 2d 2008-5608, 8/6/2008

On August 6, 2008, the US Court of Federal Claims held that the open transaction doctrine applied to shares of an insurance company acquired as part of a demutualization. Cash received was considered a return of capital.

On October 3, 2008, the government filed its Notice of Appeal with the Court of Federal Claims in the matter of *Fisher v. United States*. The US Court of Appeals for the Federal Circuit docketed the appeal on October 7; however, no briefing schedule has been placed on the docket.

Valero Energy Corp. v. US

102 AFTR 2d 2008-6564 (9/19/2008)

In a recent decision regarding Valero Energy Corp.'s claims that documents sought by the IRS as part of a tax shelter investigation are privileged, the US District Court for the Northern District of Illinois found the tax practitioner privilege does not apply to certain documents, including non-US tax advice, business or accounting advice, engagement letters, and billing sheets. In addition, the court found that the privilege does not apply to otherwise protected communication made "in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter."

Wellpoint, Inc. v. Commissioner

T.C. Memo 2008-236 (2008)

The Tax Court looked to the "origin of claim" doctrine in determining the deductibility of "conversion" payments made to resolve state lawsuits arising after conversion of three insurance companies from nonstock, nonprofit organizations to stock, for-profit organizations located in Connecticut, Kentucky, and Ohio, as well as in determining the deductibility of legal and professional expenses incurred to defend against these lawsuits. After its analysis of the "origin of claim" doctrine, the Tax Court held that the settlement payments and litigation and professional fees are capital expenditures, and therefore, not deductible under Section 162(a).

IRS rulings/procedures/notices/announcements/IRs/FAAs

Rev. Rul. 2008-8

The IRS provides guidance using examples of when a cell of a protected cell company is treated as insurance for federal income tax purposes, and when amounts paid to these cells are deductible as “insurance premiums” under Section 162. See Notice 2008-19. In general, each cell must separately account for its income, expenses, assets, liabilities, and capital from others cells as well as the overall PCC, such that they cannot be reached by creditors of other cells or of the PCC and the requirements of IRC Sections 816(a) and 831(c) must be met.

Rev. Rul. 2008-15

The IRS described the insurance excise tax consequences under Section 4371 of insurance premiums paid by one foreign insurer (foreign insurer) to another (foreign reinsurer). In particular, the ruling addresses the excise tax consequences of such payments where the foreign insurer is eligible for a waiver of the excise tax by income tax treaty but the foreign reinsurer is not. The ruling addresses both types of insurance excise tax waivers that may be provided by treaty. Rev. Rul. 2008-15 clarifies and amplifies Rev. Rul. 58-612. The ruling also relies on *United States v. Northumberland Insurance Co., Ltd.*, 521 F. Supp. 70 (D. N.J. 1981), where the court held that the premiums ceded for a reinsurance policy issued by a foreign reinsurer are taxable if the underlying policy is issued to an “insured” as defined in Section 4372(d), and there is no requirement that the reinsured qualify as an “insured” to be subject to the excise tax.

Rev. Rul. 2008-37

The IRS issued a ruling providing that, if a life insurance company does business in several states with different minimum reserve requirements, the amount of the company’s statutory reserves under Section 807(d)(6) is the highest aggregate reserve amount set forth on an annual statement pursuant to the minimum reserving requirements of any state in which the company does business. This holding is consistent with Reg. 1.801-5(a), which is cited as authority in the ruling. This regulation provides in relevant part that “In determining total reserves, a company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held during the taxable year for which the reserve is claimed.”

On its website, the IRS offered assistance to insurance companies on how to file returns in order to comply with minimum reserve requirements set forth in Rev. Rul. 2008-37. The initiative targeted companies filing a 2007 Form 1120-L, US Life Insurance Company Income Tax Return, on or after September 25, 2008.

Rev. Proc. 2008-20

The IRS provided guidance on the obligation of material advisors to prepare and maintain lists with respect to reportable transactions under Section 6112. Rev. Proc. 2008-20 specifies that material advisors may elect to use Form 13976, Itemized Statement Component of Advisee List (or successor form) to maintain the itemized statement component of the list. The revised regulations require material advisors to prepare and maintain separate lists for each reportable transaction for which a material advisor makes a tax statement on or after August 3, 2007 (and transactions of interest or after November 2, 2006).

Rev. Proc. 2008-24

The IRS released new guidance providing more beneficial parameters for taxpayers seeking tax-free treatment for “partial exchanges” of annuity contracts.

Rev. Proc. 2008-38 to 2008-42

The IRS recently finalized guidance for issuers of life insurance contracts on how to remedy (1) a failure to account for charges for qualified additional benefits under the expense charge rule of Section 7702(c)(3)(B)(ii), (2) an inadvertent nonegregious failure to comply with the modified endowment contract rules under Section 7702A, or (3) the failure of one or more contracts to meet the definition of a life insurance contract under Section 7702(a) or to satisfy the requirements of Section 101(f). The IRS also provided a procedure by which an issuer of a variable contract may remedy an inadvertent failure of a variable contract to satisfy the diversification requirements of Section 817(h) and another procedure by which an issuer of a life insurance contract may automatically obtain a waiver for certain reasonable errors that caused the contract to fail to satisfy the requirements of Section 7702 or Section 101(f).

Rev. Proc. 2008-53

The IRS provided the domestic asset/liability percentages and domestic investment yields needed by foreign insurance companies to compute minimum effectively connected net investment income under Section 842(b) for taxable years beginning after December 31, 2006.

Rev. Proc. 2008-58

The IRS provided guidance on the treatment of taxpayers accepting certain settlements of potential legal claims relating to auction rate securities. The guidance addressed these securities because of the significant number of taxpayers affected by auction failures, and the potential litigation resulting from them.

The IRS yet again made changes to Rev. Proc. 2008-58 to clarify its application to these settlement offers. The corrected revenue procedure applies to the receipt of certain settlement offers in which the taxpayer does not have to release any claims as part of the settlement offer or does not have to accept the settlement offer to benefit from it.

Rev. Proc. 2008-70 and Rev. Proc. 2008-71

The IRS released Rev. Proc. 2008-70 and Rev. Proc. 2008-71 prescribing the loss payment patterns/discount factors and the salvage discount factors, respectively, for the 2008 accident year.

These factors are used in computing discounted unpaid losses and estimated salvage recoverable under Sections 846 and 832, respectively. These revenue procedures apply to any taxpayer required to discount unpaid losses under Section 846 for a line of business using discount factors published by the Secretary, or that is required to discount estimated salvage recoverable under Section 832. The 2008 discount factors were determined using the applicable interest rate of 4.06 percent.

Ann. 2008-18

The IRS established a voluntary compliance initiative intended to encourage certain taxpayers that may have failed to pay or withhold excise taxes due under Section 4371, or failed to disclose that it has claimed a waiver from the taxes pursuant to an income tax treaty, to become compliant with its obligations. In general, if a taxpayer participates in this initiative in accordance with the terms specified in Ann. 2008-18, the IRS states that it will not conduct examinations covering insurance excise tax liabilities arising under the four situations set forth in Rev. Rul. 2008-15, or any similar fact pattern, to the extent that premiums are paid or received by the participating taxpayer during any quarterly tax period prior to October 1, 2008.

Director's Directive on Announcement 2008-18, FET Compliance Initiative (October 24, 2008)

The IRS issued a Director's Directive that provides guidance to examiners auditing taxpayers who participate in the voluntary compliance initiative established by Announcement 2008-18. This initiative was launched to encourage certain taxpayers that may have failed to pay or withhold federal excise taxes (FET) due under Section 4371, or failed to disclose that it has claimed a waiver pursuant to an income tax treaty, to become compliant.

IR-2008-41

The IRS announced its 2008 list of the 12 most flagrant tax schemes that typically lead to problems for the scam artist and taxpayers and also expose tax preparers to significant penalties, interest, and possible criminal prosecution.

Notice 2008-18

The IRS issued identified areas of concern regarding Proposed Actuarial Guideline VACARVM (VACARVM) and the potential manner in which the government may address such concerns, including Life Insurance Qualification, Life Insurance Qualification under Section 7702, contract-by-contract versus aggregate reserves, prevailing state assumed interest rate, prevailing mortality tables, and transition rules relating to application to in-force contracts.

Notice 2008-19

Notice 2008-19 proposed guidance to address the standards for determining whether an arrangement between a participant and a “cell” of a Protected Cell Company constitutes insurance, and whether amounts paid to the cell are deductible as “insurance premiums” under Section 162.

Notice 2008-42

The IRS addressed the application of Sections 101(j) and 264(f) to life insurance contracts that are subject to split-dollar life insurance arrangements. Modification of a split-dollar life insurance arrangement that does not entail any change to the life insurance contract underlying the arrangement will not be treated as a material change in the life insurance contract for purposes of Sections 101(j) and 264(f).

Notice 2008-78

The IRS provided favorable tax treatment for corporations that incurred an ownership change subject to Section 382. Notice 2008-78 provides that, notwithstanding Section 382(l)(1)(B), a capital contribution will not be presumed to be part of a plan a principal purpose of which is to avoid or increase a Section 382 limitation exclusively as a result of occurring during the two-year period ending on an ownership change date. Whether a capital contribution is part of a plan will be based on all facts and circumstances, but four safe harbor exceptions exist that will deem a contribution as not part of the plan.

Notice 2008-92

The IRS issued guidance in providing that an insurance-dedicated money market fund’s participation in Treasury’s Temporary Guarantee Program for Money Market Funds would not result in a violation of the Section 817(h) diversification requirements in the case of a segregated asset account that invests in the insurance-dedicated money market fund.

Notice 2008-94

The IRS provided guidance under the Emergency Economic Stabilization Act of 2008 (EESA), which added new Sections 162(m)(5) and 280G(e) to provide additional limitations on the deductibility of compensation paid to certain executives by employers who sell assets in the Troubled Assets Relief Program (TARP).

Private letter rulings, technical advice, and industry memorandums

PLR 200826009

The IRS has ruled that the sale or exchange of membership interests in a limited liability company classified as a partnership either by another LLC or third-party investors will not result in a transfer for a valuable consideration under Section 101(a)(2), provided that there is no termination of the partnership under Section 708(b)(1)(B).

PLR 200803022

The IRS revoked the tax-exempt status of an organization described in Section 501(c)(15) because it did not meet the operational requirements of an insurance company. The IRS determined that ORG should not be classified as an insurance company for tax purposes because its primary and predominant business activity during the relevant taxable years was its investment activity, not its insurance activity. The IRS recommended retroactive revocation of the determination letter because there were omissions and misstatements of material fact during the application process and also a material change in operation. ORG's status was revoked as of the date of inception, as identified in ORG's determination letter.

PLR 200807001

The IRS ruled that upon termination of participation of any private or semiprivate entities of one Association's benefit plan administered by another Association, the income will be excludible from gross income under Section 115(1) of the Code, which provides that gross income does not include income derived from the exercise of an essential governmental function and accruing to a state or a political subdivision of a state. In Rev. Rul. 77-261, 1977-2 C.B. 45, income from a fund established under a written declaration of trust by a state for the temporary investment of cash balances of the state and its political subdivisions, is excludable from gross income under Section 115.

By assisting local governments to provide for the cost-effective acquisition, treatment, and distribution of water to the inhabitants of State, Association performed an essential governmental function within the meaning of Section 115(1).

PLR 200809013

The IRS granted an insurance company an extension to make an election under Section 953(d) to be treated as a domestic corporation for US tax purposes. Reg. Section 301.9100-1(c) provides, in part, that the commissioner has discretion to grant a taxpayer a reasonable extension of time to make a regulatory election. Reg. Section 301.9100-3(a) provides that requests for relief will be granted when the taxpayer provides the evidence to establish to the satisfaction of the commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the government. Under Reg. Section 301.9100-3(b)(1)(v), one condition under which the taxpayer is deemed to have acted reasonably and in good faith is that the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make or advise the taxpayer to make the election.

PLR 200809034

The IRS revoked ORG's exemption status because it did not meet the operational requirements of an insurance company as described under Section 501(c)(15). When the IRS reviewed the detail behind ORG's activities, they concluded that the policy contracts written did not constitute "insurance" because they do not involve both risk shifting and risk distribution, as established in *Helvering v. LeGierse*, 312 US 531 (1941). The IRS also found that ORG should not be classified as an insurance company for tax purposes because its primary and predominant activity during the taxable year 20XX was not its insurance activity. Rather, the majority of ORG's income during 20XX was attributable to its income from its investments and sales of marketable securities.

PLR 200819003

The IRS ruled that the failure of a stock life insurance company's policies to meet the definition of a life insurance contract under Section 7702(a) was due to a reasonable error and granted the company a waiver under Section 7702(f)(8) for any contracts that are cured within 90 days of the ruling.

PLR 200820009

The IRS ruled that neither the assumption of insurance and annuity contracts nor modifications to those contracts resulting from the assumption will affect the contracts under the relevant Code sections, constitute a disqualifying distribution, or result in income to contract beneficiaries.

PLR 200822040

The IRS revoked the tax-exempt status of an organization described in Section 501(c)(15) because it failed to meet new requirements enacted by statute, including a requirement that its gross receipts not exceed certain dollar limitations.

PLR 200824024

The IRS ruled that an insolvent corporation was not required to file as an insurance company exempt from federal income tax under Section 501(c)(15).

PLR 200829053

The IRS revoked the tax-exempt status of an insurance organization described in Section 501(c)(15) for two tax years because it did not meet the qualifications for exemption. Even though ORG was able to meet the $600,000 gross receipt limitation, its premiums did not exceed 50 percent of the gross receipts. As a mutual company, ORG was able to meet the $150,000 gross receipt limitation, but its premiums did not exceed the 35 percent limitation required for mutual companies. Because ORG did not meet the requirements of Section 501(c)(15), the IRS also recommended that the company file Forms 1120/1120-PC for the relevant years.

PLR 200830022

The IRS ruled that the income from a trust created by a state agency to fund post retirement health benefits for retired employees of the agency is excludable from the agency's gross income under Section 115 and that contributions to the trust will be excludable from the retiree's gross income under Section 106.

PLR 200831028

The IRS ruled that an insolvent Section 501(c)(15) insurance company in receivership satisfies the transition rule under Section 206(e)(2) of the Pension Equity Funding Act of 2006 and qualifies as a tax exempt through 2007.

PLRs 200836038 and 200836043

In two almost identical rulings, the IRS issued determinations that the insurance companies' exemptions under Section 501(c)(15) should be revoked because premium income is less than 50 percent of their total gross receipts, and therefore the entities failed to meet new requirements for exemption imposed by the Pension Funding Equity Act of 2004.

PLR 200838018

The IRS ruled that failure of a Section 816(a) life insurance company's policies to meet the federal tax definition of life insurance contracts under Section 7702 was due to a reasonable error and that the company qualifies for a waiver of reasonable errors because it has taken steps to correct the errors.

PLR 200841034

The IRS granted an insurer a waiver on the failure of life insurance contracts to satisfy the cash value accumulation test of Sections 7702(a)(1) and 7702(b).

PLR 200842049

The IRS concluded that ORG was not operating as an insurance company and therefore was not eligible for exemption under Section 501(c)(15).

PLR 200842052

The IRS revoked the tax-exempt status of an insurance organization because it did not meet the qualifications for exemption under Section 501(c)(15). As a result of an examination, the IRS determined that the taxpayer included certain depreciation and bank fees in investment income, which the IRS concluded should have instead been reported separately as expenses on the Form 990 filed in 20XX. The IRS also determined that the total amount of commissions received from the reinsurer that ORG reported as other income on Form 990 should have instead been deducted from the total amount of reinsurance premium payments. The commissions were already reported as premium income when they were first received by ORG.

PLR 200842038

The IRS held that a conversion transaction between a government and newly formed mutual insurance company should be treated as a Section 351 stock transaction.

PLR 200843026

The IRS ruled that a company issuing extended vehicle contracts is an insurance company under Section 831(c). The contracts, which were insurance contracts containing, inter alia, indemnification agreements between the company and an unrelated insured, were considered to be reinsurance contracts for federal income tax purposes.

PLR 200845043

The IRS ruled that (1) the extended service contracts (ESCs) issued by Newco would be treated as insurance contracts and (2) Newco would be treated as an insurance company for federal income tax purposes.

PLRs 200815021 and 200815022

The IRS ruled that the income from a trust created by a state agency to fund insurance benefits for retired state employees is excludable from the agency's gross income under Section 115 and that contributions to the trust will be excludable from the retiree's gross income under Section 106.

PLR 200850011

The IRS concluded that Taxpayer's wholly owned captive insurance subsidiary qualified as an insurance company and that the ESCs it reinsured under a reinsurance contract with another one of Taxpayer's subsidiaries constituted insurance. Economic substance continues to be one of the components considered in determining the existence of an insurance risk.

PLR 200851026

The IRS concluded that the tax exemption status of ORG for the years beginning October 1, 20XX should be revoked because it did not meet Section 501(c)(15) exemption qualifications. ORG was not involved in any reinsurance contracts. No premiums were ceded during the year ending September 30, 20XX.

PLR 200852037

The IRS held that a charitable organization's (ORG's) sale of annuities through a charitable gift annuity program would not constitute commercial-type insurance under Section 501(m) and that income from the program will not constitute income from an unrelated business under Section 513.

TAM 200809045

The IRS concluded that a reinsurance company does not qualify for exemption from income tax under Section 501(c)(15) for a period of tax years and cannot rely on a determination letter in which the IRS allowed it to claim tax-exempt status. According to the IRS, Company M did not qualify as an insurance company for the following reasons: (1) the investment activities were significantly greater than insurance activities; (2) premium income was small in comparison to investment income; (3) year-end reserves for claims for each year were less than one-half of 1 percent of statutory surplus; (4) Company M did not solicit new business; (5) no additional capital was sought, even when the owner acknowledged that the company might be undercapitalized; (6) Company M had only one employee, N, who was the sole shareholder.

TAM 200807018

The IRS revoked an organization's exemption status because ORG did not operate as an insurance company as described under Section 501(c)(15). ORG conceded it did not meet the gross receipts and premium requirements for years beginning January 1, 2004. The IRS focused predominantly on the actual activities of the entity and concluded that the policy contracts written did not constitute "insurance" because they do not involve both risk shifting and risk distribution, as established in *Helvering v. LeGierse*, 312 U.S. 531 (1941).

TAM 200816029

The IRS considered whether the general partner or the limited partnership should be deemed the insured entity under a purported insurance arrangement for purposes of evaluating whether sufficient risk distribution exists among the entities to treat the arrangement as insurance for federal income tax purposes. The IRS concluded that when an entity classified as a partnership for federal income tax purposes is of the type that has a general partner, because the general partner is ultimately liable for the liabilities of the entity (in excess of the assets of the partnership), it is the general partner whose risk of loss is shifted under the insurance contract. Hence, it is the general partner who should be considered the insured under liability coverage for purposes of evaluating whether an arrangement constitutes insurance for federal income tax purposes. (The IRS included a caveat to their conclusion where local law subjected the limited partners to the same levels of liability as the general partner.)

TAM 200824028

The IRS ruled that an insurance company in run-off did not qualify as a tax-exempt insurance company described in Section 501(c)(15) because its primary activity was investing, not insurance.

TAM 200827006

The IRS concluded that a multiline retailer's purchase of warranty reimbursement insurance policies from a related captive insurance subsidiary designed to reimburse the retailer's losses under its manufacturer's warranty obligation offered to customers of the retailer did not constitute insurable risks for federal tax purposes.

PLR 200810031

The IRS ruled that an insolvent insurance company in receivership qualified for the transition rule under the Pension Funding Equity Act for companies in receivership or liquidation because it established both requirements of Section 206(e)(2) of the Act and, therefore, its tax-exempt status would continue.

ILM 200844011

The IRS concluded that Section 4371 applied to premiums paid by a foreign taxpayer to a domestic pool because the premiums were paid to a foreign insurer or reinsurer for insurance policies, indemnity bonds, annuity contracts, or reinsurance contracts.

ILM 200813042

The IRS concluded that retired insurance agents' rights to renewal commissions under an insurance company's commission plan constitute nonqualified deferred compensation plans and that the renewal commissions are subject to FICA tax when the commissions are paid to the retiree.

LMSB-04-0308-010

The IRS Large and Midsize Business Division (LMSB) issued an industry directive to provide guidance to agents on the examination of the dividends received deduction (DRD) incurred in connection with separate accounts of life insurance companies.

LMSB-04-0408-024

In a coordinated issue paper, the IRS outlined its primary and alternative positions on the federal tax consequences resulting from conversions from nonprofit to for-profit status by Blue Cross Blue Shield and similar taxable nonprofit organizations.

Regulations

T.D. 9377

The IRS released final regulations and removed temporary regulations relating to an actual or deemed acquisition of an insurance company's assets. The final regulations were released under the following Sections: (1) Section 197 relating to the determination of adjusted basis-of-amortizable Section 197 intangibles with respect to insurance contracts and the interplay of Section 197 and Section 848, which requires the capitalization of certain policy acquisition expenses; (2) Section 338 relating to increases in reserves after a deemed asset sale; and (3) Section 846 relating to the effect of a Section 338 election on an insurance company's Section 846(e) election to use its historical payment pattern to discount certain unpaid losses.

T.D. 9364

The IRS issued final regulations regarding information reporting on employer-owned life insurance contracts to provide taxpayers guidance in applying Section 6039I requirements. The final regulations replace temporary regulations published November 13, 2007. Effective for tax years ending after November 6, 2008, the final regulations generally provide that every applicable policyholder that owns one or more employer-owned life insurance contract issued after August 17, 2006 shall file a return.

T.D. 9385

The IRS issued final regulations on the diversification requirements of Section 817(h) that expand the list of holders whose beneficial interests in an investment company, partnership, or trust do not prevent a segregated asset account from looking through to the entity's assets to satisfy the requirements of Section 817(h). The IRS has previously addressed these look-through rules in several other rulings, including PLRs 200010020, 200508002, 200613028, 9820004, 9828015, and 9847017.

T.D. 9386

The IRS issued final regulations on the availability and character of a loss deduction under Section 165 for losses sustained from abandoned stock or other securities. Under the final rules, a loss from an abandoned security is governed by Section 165(g), and the loss is allowed only if all rights in the security are permanently surrendered and relinquished for no consideration.

Ann. 2008-25, 2008-14 I.R.B. 732

The IRS withdrew a portion of proposed Reg. Section 1.1502-13(e)(2)(ii)(C) (72 FR 55139) published in September 2007 relating to the treatment of transactions involving the provision of insurance between members of a consolidated group. Under the proposed regulations, certain intercompany insurance transactions would be taken into account on a single-entity basis.

73 F.R. 19588-19589

The IRS solicited comments concerning an existing final regulation that provides needed guidance to persons who enter into split-dollar life insurance arrangements. The regulation relates to the income, employment, and gift taxation of split-dollar life insurance arrangements.

T.D. 9418

The IRS released final regulations under Section 408A providing guidance on the tax consequences of converting a non-Roth individual retirement annuity to a Roth IRA.

T.D. 9424

The IRS issued final regulations under Sections 358, 362(e)(2), and 1502 providing rules to determine the tax consequences of a member's transfer of loss shares of subsidiary stock. The final regulations also provide that Section 362(e)(2) generally does not apply to transactions between members of a consolidated group.

Appendix B

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