PricewaterhouseCoopers

# Continuing Developments in the Taxation of Insurance Companies

## 2001–The Year in Review

# CONTINUING DEVELOPMENTS IN THE TAXATION OF INSURANCE COMPANIES

2001–The Year in Review

# Table of Contents

## Chapter Five: Reorganizations



## Chapter Six: International Developments



## Chapter Seven: Products



## Chapter Eight: Other Federal Issues

# Chapter 1

## The Year in Review

# Introduction

In January 2001 the Congressional Budget Office predicted the cumulative federal budget surplus would reach $5.6 trillion between 2002 and 2011,[1] the result of a record economic expansion the United States enjoyed throughout the 1990's. In an effort to return the surplus to the people and stimulate the slowing economy, the young George W. Bush Administration garnered support for tax cuts promised in the 2000 presidential campaign. The Economic Growth and Tax Relief Reconciliation Act of 2001 delivered on most of those promises, providing for the phase-in of individual tax rate cuts, education incentives, estate tax relief, and increased AMT exemptions. Bush promised to focus on education reform, Social Security reform and additional tax relief (including corporate and marriage penalty) in 2002.

By March of 2001 the slowing U.S. economy sank into a recession ending 10 years of sustained growth.[2] The advent of the recession marked the end of the longest expansion on record in the U.S. Both industrial production and Gross Domestic Product (GDP) went negative by the end of the summer. Across industries, companies cut thousands of jobs as they retrenched in response to the economic slowdown.[3] The Federal Reserve Board began easing monetary policy, leading many to predict that the recession would be short lived.

The September 11 terrorist attack on the Pentagon and the World Trade Center destroyed hopes of a quick economic recovery. Consumer confidence plummeted, stock markets tumbled, and travel industries were devastated as Americans stayed home. Insurance companies projected $20 billion to $30 billion in potential losses from damage sustained in the attack. The National Bureau of Economic Research indicated that the economy might have been able to avoid the recession without the impact of the September 11 attack.[4] These events completely changed the focus of the Bush presidency.

[1] Source: Congressional Budget Office

[2] *The Business-Cycle Peak of March 2001*, National Bureau of Economic Research (NEBR), nebr.org, 11/26/01

[3] *Surviving a recession: Part 1 the fear factor*, CNN.com, 10/23/01

[4] *Economists call it a recession*, CNN.com, 11/26/01

Overnight George W. Bush changed from the education president to a president dedicated to wiping out global terrorism and restoring the U.S. economy. The Administration immediately focused on securing the national defense, bailing out the ailing travel industries, and confirming the continued solvency of the insurance industry while extracting promises that claims would be paid. President Bush ordered an all out military and economic assault on terrorists and those that harbor them. On October 7, a U.S. led international coalition began an intense bombing campaign while financial assets around the world linked to terrorist organizations were seized.

Bush called on the country to not let the terrorists win; to "get back to normal." The Administration sought financial relief for those affected by the attacks and followed up with an economic stimulus proposal including significant corporate tax benefits. Congress acted swiftly with bi-partisan action to provide economic and tax relief for those immediately affected by the attacks. $40 billion dollars was allocated to New York City and the airline industry. Unfortunately, soon after this patriotic show of unity, Congress "got back to normal" by breaking down on party lines and failing to pass an economic stimulus bill, a terrorism reinsurance bill, or any other significant legislation.

At the end of 2001 Bush enjoyed a ninety percent approval rating, legitimized as America's president after the controversial 2000 election. However, the Administration continues to face a difficult task protecting U.S. citizens and interests from further attack and economic loss. The slowing economy and resulting job losses caused an unanticipated decrease in federal tax receipts. The significant increases in unemployment caused a corresponding spike in government expenditures. The Senate Budget Committee is projecting a $1 billion deficit for the fiscal year beginning October 1, 2001.[5] The combination of these factors with the decreased federal revenues related to the March tax cuts, have decreased the $5.6 trillion federal budget surplus projected early in 2001 to less than $2 trillion over the same period.[6]

[5] *Recession wiped out '02 surplus, report says*, Jonathan Weisman, USA Today, 1/10/02

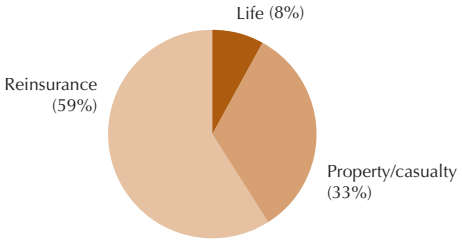
[6] *Id.*

# Events of September 11

## *Insurance Industry Losses*

While the final costs to the insurance industry will not be known for many years, it is clear that the September 11 events will produce the single largest insurable event to date. Within days of the attack, estimates of insurance industry losses were released to the public, ranging widely between a low of $15 billion[7] to a high of $100 billion.[8] Loss estimates settled at approximately $22 billion in the following weeks.[9] The Property & Casualty industry and the Reinsurance industry are expected to bear the brunt of these losses as most claims are expected to relate to property damage, business interruption, and workers' compensation.

**NET WORLD TRADE CENTER LOSS EXPOSURE BY INDUSTRY SECTOR**




Source: Standard & Poor's Online, October 29, 2001

Many feared that insurers would attempt to invoke "war clauses" to deny coverage. This fear proved to be unfounded as key insurers indicated early on to both the Administration and the public that they would expeditiously pay all claims.

There was further concern that the solvency of the reinsurance market would be tested by the enormity of the terrorist related claims. Analysts quickly dispelled this concern, stating that the insurance companies have

[7] *Industry Can Bear Burden*, USA Today, Christine Dugas and Julie Appleby, 12/4/01

[8] *$75 Billion? The Guessing Continues*, National Underwriter. Susanne Sclafane, October 1, 2001 (p.6)

[9] *Global Insurance Remains on Solid Ground Following Terrorist Attacks*, Standard & Poors, standardandpoors.com, 10/29/2001

the financial ability to keep promises they've made to their policyholders.[10] However, the financial impact of paying these claims has had an effect on insurers' profitability and the drop in the stock market has compounded that problem.

> *One area of note is the brewing litigation of whether the attack on the World Trade Center is considered a single event or two separate events for purposes of the leaseholder's insurance claims. Due to per event caps in the policy, if the attack is found to constitute a single event, the insurers will be required to pay out approximately $3.6 billion That figure will double to approximately $7.2 billion if deemed two events. The court's findings with respect to this controversy will likely determine a new point of insurance law.*

## *Economic Impact*

The New York Stock Exchange shut down for an unprecedented three days immediately following September 11. On September 17, prior to the resumption of trading, the Federal Reserve cut the Fed Funds rate by 500 basis points. Despite the rate cut, upon re-opening the Dow plummeted 700 points (7.5%) amid investor panic. Since the low point on September 21 the markets have rebounded. The Dow Industrial Average increased from 9,605 to 10,021at the end of 2001, showing a 416 point gain over its pre-attack level.

Industries hardest hit by the bear market included the airlines, tourism (e.g. hotels, restaurants, etc.), and insurance. Already working with a thin profit margin, airlines immediately announced layoffs. Travel agencies around the U.S. also closed as tourism declined. Domestic production continued to slide causing automakers and other manufacturers cut their employment rolls. Over eight hundred thousand non-farm jobs were lost between September and December of 2001.[11] The sharp market decline and the widespread industry decline further exacerbated the insurance surplus strain as investments gains turned to investment losses.

[10] Id. at 7

[11] Bureau of Labor Statistics

*Further complicating the economic picture was the collapse of Enron. In January 2001, Enron, a Houston based multi-national energy company, had a market capitalization of approximately $60 billion with a stock price in excess of $81 per share.*[12] *In the fall of 2001, Enron disclosed improper financial accounting that had led to a $600 million overstatement of profits.*[13] *As the value of Enron stock dropped, employees holding significant amounts of Enron stock through their 401(k) plan were unable to sell while corporate executive sold their shares for an alleged $1.1 billion profit.*[14] *On December 2, 2001 Enron set a record for the largest U.S. bankruptcy protection filing with $62.8 billion of assets.*[15] *Allegations of fraud and slumbering accountants have prompted a criminal investigation by the U.S. Department of Justice. Although no special assistance appears to have been provided, claims of "White House Access" and Congressional influence has already prompted new calls of scandal and campaign reform. The impact of this failure will ultimately be felt by the accounting profession and the SEC and not just by Enron stockholders and employees.*

## Insurance Industry Changes

Prior to 2001, the Property & Casualty insurance industry had experienced a prolonged soft market. Insurance rates had generally declined since the mid 1980's. Widespread underwriting losses had been buoyed by huge investment gains; however, the downturn in the market caused insurers to re-evaluate their underwriting criteria. As a result, prices began to increase in mid-2000 and continued to accelerate in 2001, even before the events of September 11. The U.S. Property & Casualty industry posted a $3.1 billion dollar loss for the first nine months of 2001 as compared to $16.8 billion in net income for the same period in 2000.[16]

[12] *'Nervous' employee warned Enron CEO*, CNN.com, 1/14/02

[13] *Enron's Chairman Received Warning About Accounting*, Don Van Natta, Jr. and Alex Berenson, New York Times, 1/15/02

[14] *DOJ in Enron criminal probe*, CNN.com, 1/9/02

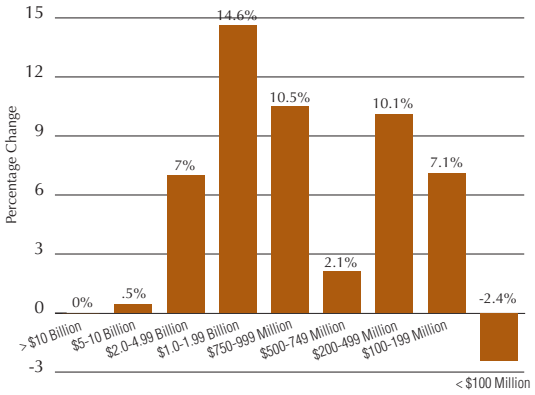
[15] Id. at 12

[16] *First-ever nine-month net loss for property/casualty industry in wake of September 11 attack and deterioration in investment results*, Dow Jones News Service, 12/19/2001

The industry's surplus fell 11.2% to $281.9 billion at September 30 from $317.4 billion at year-end 2000.[17] Not surprisingly, the insurance industry has accelerated premium rate increases and has implemented larger deductibles on its policies in all lines of business in an effort to recover prior losses and ease surplus strains.

As a result of the hardening market and opportunities for profit, new insurance and reinsurance companies have been formed offshore at a brisk pace, while billions of dollars of fresh capital have been committed to existing facilities.[18] Even as billions of dollars are raised, it is estimated that the capital infusion to date falls well short of the capacity that has left the market or is earmarked for future growth.[19] Despite these efforts to increase capacity in the reinsurance market and other efforts to garner government protection, the hardening of the insurance market, along with the associated decreases in coverage, has prompted companies to investigate captive insurance arrangements and other alternative risk management arrangements.

PREMIUM GROWTH – BY COMPANY SIZE




2000 Net Written Premiums

Source: NAIC

Source: National Underwriter, July 23, 2001

[17] Id.

[18] *Bermuda attracts billions of capital for new facilities*, Business Insurance, 12/10/01

[19] Id.

The advent of "terrorist exclusions" in policies and separate "terrorist action" coverage has raised uncertainty regarding how future business will be conducted in the U.S. without insurance protection for terrorist acts. The Reinsurance industry has moved to write new and renewal policies to exclude coverage for claims related to "terrorist actions," covering "terrorist action" in separate policies. Primary insurers are seeking similar exclusions, but those direct policies are generally subject to state regulatory approval. It is not yet clear how state regulators will view such exclusion provisions; however, indications are that state regulators are leaning toward approving such exclusions unless the federal government delivers a backstop measure to protect primary insurer solvency.[20]

## Government Responses and Proposals

### *Terrorism Bill*

In an effort to address the new terrorist threat to insurance solvency and solve perceived problems with potential "terrorist exclusion" insurance policy provisions, the House passed legislation calling for the creation of a government terrorism reinsurance program which, among other things, provided for the recognition of terrorism reserve deductions for federal income tax purposes. The Senate prepared draft compromise legislation regarding terrorism insurance.[21] The Senate version provided for a one-year federal reinsurance program and was widely expected to pass.

Ultimately the bill did not pass as partisan bickering focusing on tort limits ensued. Many believe that Congress is now waiting to see the impact of "terrorist exclusions" on the functioning and financial well being of the U.S. economy, noting the publicized concerns about lending for developers, and lease coverage for the airline industry. If no such economic "derailment" occurs in 2002 they may simply let the industry and the markets resolve this issue naturally.

[20] *NAIC President: If Congress doesn't act on terror insurance, regulators will start approving exclusion*. Best's Insurance News, 12/31/2001

[21] H.R. 3210

The provisions of both versions of the proposed insurance protection legislation represent huge undertakings, and have raised a number of questions regarding their implementation. Questions regarding the non-deductibility of the related terrorism reserves, much like other natural catastrophe reserves, have been raised. This may be the time for the catastrophe reserve proponents to reconvene and revise their plan; it is likely Congress may be more receptive now.

> ***The terrorist attacks that toppled the World Trade Center and damaged the Pentagon also put an end to the bitter budget battle over spending the Social Security trust fund surplus and delayed debate over additional tax cuts. Former House Budget Committee GOP staff director Rick May said that debate could just as well have happened "20 million years ago" as one week before the attacks because billions of Social Security trust fund dollars will now be spent to respond to terrorism.***
>
> Source: BNA Daily Tax Report, September 17, 2001

## Economic Stimulus Legislation

Bush proposed, and the House passed an economic stimulus bill directed toward accelerating the economy's recovery. Provisions of the bill focused primarily on corporate tax incentives including:

- Enhanced expensing of capital assets
- Repeal of preferences and 90% NOL/Foreign Tax Credit limitation
- Extension of NOL carryback periods
- Extension of expiring provisions (e.g., Subpart F active financing exception)
- Increase in small business expensing
- Acceleration of the reduction in marginal tax rates
- Medical insurance tax credits for unemployed
- Extension of unemployment benefits.

The cost of the House package was estimated to total $90 billion in 2002. The House passed their bill well before year-end.

The Senate proposed its own more moderate stimulus package, costing a mere $67 billion in 2002. The package was blocked from a vote on the Senate floor amid debate regarding the magnitude of tax cuts and the appropriateness of an economic stimulus package at all. The decline in the projected surplus was also a major factor in the debate. It is expected that pieces of the economic stimulus provisions contained in the House bill will be incorporated in the Administration's March 2002 budget proposal.

## Federal Reserve Action

Throughout 2001 the Federal Reserve worked to exercise its influence over the economy in an effort to keep consumers spending and help lessen the severity of the economic downturn.[22] Even before the September 11 crisis, U.S. GDP had dropped from over 8% at the end of 1999 to less than 1% through the second quarter of 2001. In response to the slowdown, the Federal Reserve cut the Fed Funds rate six times, from a high of 6.5% to a low of 3.5% in an effort to reverse this trend prior to the attack. Following September 11, the slowdown severely intensified. Unrevised GDP in the third quarter dropped to negative 0.4%.[23] Five additional Federal Reserve rate cuts reduced the Fed Funds rate to 1.5% by the end of 2001. In January 2002, Alan Greenspan indicated that he has seen signs of economic stabilization and expressed optimism that the economy would overcome the shocks of 2001 and return to its long-term prospects for growth.[24]

## IRS Action

The IRS announced that it would grant disaster relief for taxpayers affected by the terrorist attacks. Notice 2001-61 provided "extensive relief" to taxpayers located in five New York counties (Bronx, Kings,

[22] Id. at 4

[23] Department of Commerce, Bureau of Economic Analysis

[24] *Greenspan Sees Signs of Economic Stabilization*, Patti Mohn, Tax Analysts, 2002 TNT 9-2

New York – Brooklyn and Manhattan – Queens, and Richmond) as well as Arlington, Virginia. "Extensive relief" as defined by the Notice included the following components:

- Individuals who had extended their 2000 tax returns beyond September 10, 2001 had until February 12, 2002 to file their returns.
- Taxpayers other than individuals (corporations, partnerships, etc.) had an extra 120 days to file returns otherwise originally due on or after September 11, 2001, and on or before November 30, 2001, and to pay the tax shown on those returns. Affected calendar-year corporations and other entities currently on a six-month extension of time to file that expires between September 11, 2001 and November 30, 2001 had an additional 120 days to file as well.
- The due date of estimated tax payments originally due on or after September 11, 2001 and before January 15, 2002 for these taxpayers was postponed until January 15, 2002.

The Notice also granted limited relief to any other taxpayers affected by the terrorist attack due to transportation or document delivery disruptions regardless of their principal place of business or residence. These taxpayers had until November 15, 2001, to file their returns and make payments required for the period September 11, 2001 through October 31, 2001.

*The IRS has announced that for the first time the General Accounting Office has issued a "clean" opinion of all of the IRS's financial statements for fiscal year 2000. A clean opinion, says the IRS, means that the GAO audited IRS financial statements and attested that they account for IRS total revenue collections of more than $2 trillion, refunds of more than $190 billion, and total IRS appropriations of more than $8.3 billion.*

Source: Tax Analysts, March 5, 2002

Finally, the Notice provided that taxpayers having difficulty in making timely Federal tax deposits required to be made from September 11, 2001

through October 31, 2001 would not be subject to penalties for failure to timely make any deposit if the deposit was made on or before November 15, 2001. This penalty relief applies only to taxpayers that are unable to meet their deposit obligations because their (or their service provider's) records, computers, or other essential supporting services were damaged, or essential personnel were injured, by the attacks.

## New Legislation and Guidance

Although the events of September 11 and the tumbling economy overshadowed almost all other activity throughout the year, the courts and the Treasury Department still managed to continue their work. The courts decided a number of cases that impact the taxation of insurance companies and direct their future tax planning. The IRS also continued its quest to extend its recent "sham transaction" victories, to attack loss reserve redundancy, and to focus on captive insurance issues. The courts and administrative guidance are mixed with respect to taxpayer victories; however, they shed some light on important issues.

Late in the spring, the Treasury Department and the IRS issued the "2001 Priority Guidance Plan," listing the guidance they expected to issue in 2001. Six items specifically related to insurance companies and products. Guidance issued in 2001 concerns captive insurance companies, IRC §807, IRC §41 research credits and split-dollar life insurance. This guidance is discussed in more detail throughout this monograph.

## Outlook for 2002

Other than Alan Greenspan's interest rate manipulation and an initial bailout package for New York and the airlines, there has been little intervention by the U.S. government into the U.S economy. While economic stimulus package proposals primarily focusing on tax cuts have been the Bush Administration's answer to the economic crisis so far, it has had no success in convincing Congress that additional measures are necessary and appropriate. The lack of substantive response to the events of 2001 leave many policy initiatives unresolved.

Already members of Congress are calling for a stop to the phase-in of many of the tax cut provisions in The Economic Growth and Tax Relief Reconciliation Act of 2001. As a result, long awaited marriage penalty relief and the looming individual and corporate AMT crisis will likely continue to wait for resolution. In addition, taxpayers are waiting to see how Congress will address the expired Subpart F active financing exceptions and the R&D credit extension. Potential government funded reinsurance legislation and continued tax cut legislation have the potential of significantly changing the manner in which insurance business is conducted in the U.S, while answers to the more mundane questions of the repeal of life/nonlife rules, the DEA adjustment, and IRC §815 await. Moreover, education and social security reforms have yet to be addressed and debated. As the congressional election season swings in to gear, the country's policy direction depends on the outcome of the November 2002 elections.

Many Americans are looking to the government for answers to the ailing economy and protection from terrorism. As a result, America's new focus on security has led to widespread support for government military operations overseas, domestic security initiatives, and actions to provide protections and stimulus to the ailing economy. The fear instilled by the attacks on September 11 significantly impacted America's psyche. On December 17 the University of Michigan released its annual report on how satisfied Americans are with the federal government that stated filing taxes was a more favorable experience than flying on commercial airlines.

# Chapter 2

## Legislation

Although tax legislation got a running start with the Economic Growth and Tax Relief Reconciliation Act of 2001, bipartisan agreements came to a screeching halt with Senator Jeffords' dramatic switch to the Independent party in late May. Following the change of control in the Senate, and despite a unified front after September 11, Congress did not manage to pass any major tax initiatives, and none directly affecting the insurance industry.

After the September 11 terrorist attacks, several items of legislation relevant to the insurance industry were introduced. These items included a money-laundering anti-terrorism bill, an economic stimulus bill, and a reinsurance bill that would have provided a government reinsurance program for terrorism. Among the bills introduced, only the money-laundering anti-terrorism bill and the Victims of Terrorism Tax Relief Act became law.

> *"I will leave the Republican Party and will become an independent," Jeffords said, prompting cheers and thundering chants of "Thank you Jim!" from supporters both inside and outside the room. Jeffords said he would caucus with the Senate's Democrats "for organizational purposes." His defection breaks the party deadlock in the upper chamber, which had been evenly divided. Jeffords said his switch would not become effective until the president signed a final tax bill into law.*
>
> Source: CNN.com, May 24, 2001

## The Economic Growth and Tax Relief Reconciliation Act of 2001 – HR 1836

As President Bush's campaign budget showed signs of becoming a reality, many doubted that the budget surplus would be sufficient to fund all programs. Despite these concerns, the $1.35 trillion tax cut became law on June 7, 2001. The bill focused on the individual taxpayer and largely ignored the corporate sector. Among the few corporate provisions were changes in dates for estimated tax payments, easing of nondiscrimination rules applicable to 401(k) plans, and expansion of the current employer deduction for dividends paid on certain stock. It should be noted that the provision to permanently extend the R&E credit was not included in the bill. The extension of the Subpart F active financing provision and sections relating to health care were also not in the final bill.

The individual tax provisions in the bill included phased-in repeal of the estate and generation-skipping transfer taxes, a new 10-percent individual income tax bracket retroactive to January 1, 2001, marriage penalty relief after 2004 and an increased individual AMT exemption, and an increased annual contribution limit on 401(k) plans and IRAs. Due to budget constraints, all the tax cuts in the bill will "sunset" or terminate on December 31, 2010 unless they are extended by Congress.

During the course of the year, several bills introduced in previous congressional sessions were re-introduced. Items of interest to insurance companies included the repeal of Sections 809 and 815, the life/non-life consolidation bill, and the so-called Bermuda bill.

*Average U.S. taxpayers must work until May 3 to earn enough money to pay their federal, state, and local taxes, according to an April 13 report by the Tax Foundation. "Tax Freedom Day" arrived one day later in 2001 than it did in 2000, the report said. The 123-day period is the longest taxpayers ever have had to work to pay their taxes, the report said.*

Source: BNA Daily Tax Report, April 16, 2001

## Life Insurance Simplification Act – H.R. 661

Once again, legislation was introduced that would repeal the Section 809 differential earnings adjustment on policyholder dividends of mutual life insurance companies and the Section 815 income inclusion from policyholder surplus accounts.

Amo Houghton (R, NY) introduced The Life Insurance Simplification Act of 2001, stating that the two sections no longer served valid tax policy goals and had become outdated. Section 809 was originally enacted to protect the competitive interest of stock companies when mutual companies dominated the market; however, today mutual life companies make up only approximately 10 percent of the industry. Section 815, which was enacted more than forty years ago, allowed life insurance companies to defer tax on half of their underwriting income as long as it was not distributed to shareholders. Although this deferral no longer exists, the policyholder surplus accounts are only subject to tax when a triggering event occurs. The bill as introduced did not include a recapture provision.

The bill was referred to the House Committee on Ways and Means, but never came to a vote.

Kent Conrad (N-N.D.) and Robert Torricelli (D-N.J.), introduced S. 992, a companion bill to H.R. 661. The bill would have repealed Internal Revenue Code Sections 809 and 815. S. 992 was referred to the Senate Committee on Finance, but like the House bill, received no further consideration in 2001.

> *Senator Joseph Lieberman and Delegate Eleanor Holmes Norton introduced identical bills that would absolve residents of the District of Columbia from federal income taxation unless they gain full voting representation in the House and Senate. Currently, the District of Columbia is allowed one seat in the House, which can express the district's voice, but not vote in the Congress.*
>
> Source: Tax Analysts, March 26, 2001

## Life Insurance Company Consolidation – H.R. 909

Congressman Phil Crane (R-IL) again introduced a bill that would have permitted the current consolidation of life and nonlife insurance companies, effective for tax periods beginning after December 31, 2000.

H.R. 909 would have eliminated the present five-year waiting period. Additionally, for tax years between December 31, 2000 and January 1, 2007, there would have been a phase out of the limitation on non-life losses. That is, the 35% allowable non-life offset would increase to 100% from 2001-2007.

The bill also contained a provision disallowing the carryback prior to January 1, 2001 of a consolidated net operating loss created or increased due to the changes outlined above. In a "true-up" provision, a parent's basis in a subsidiary's stock would have been adjusted to reflect income, gain, deduction, and loss incurred while companies were members of an affiliated group–but not included as part of the consolidated group–under existing law.

The bill was referred to the House Ways and Means Committee, but did not receive further consideration.

> *The Organization for International Investment criticized House bill H.R. 1755, intended to prevent domestic nonlife insurance companies from reducing U.S. income taxes through the use of reinsurance with foreign affiliates. The measure would deter U.S. companies from relocating their businesses to Bermuda and other tax haven countries. OFII's letter, however, said the bill is a protectionist measure that would impair the free flow of international capital, goods, and services, "ultimately harming consumers and the functioning of the global marketplace."*
>
> Source: BNA Daily Tax Report, August 29, 2001

## Reinsurance Tax Equity Act of 2001–H.R. 1755

Another bill introduced, but not passed, in 2001 would have amended Section 832, with some exceptions, to defer the deduction for the reinsurance of U.S. risks with a related reinsurer. The "Reinsurance Tax Equity Act" was introduced by the same legislators who supported last year's "Bermuda Tax Haven" bill. However, in contrast to the previous bill in which domestic insurers would pay tax on imputed income for reserves related to the reinsurance of U.S. risks to "tax havens," this bill would instead focus on disallowing the tax deduction for premiums paid until loss recovery.

The "Reinsurance Tax Equity Act of 2001" would have amended this subsection to disallow a deduction for premiums paid for U.S. risks reinsured with a related reinsurer, with some exceptions.

*The Board of Directors of the Captive Insurance Companies Association, the only global association representing the captive insurance industry, has voted to express its strong opposition to recently introduced legislation (H.R. 1755), which would change current tax provisions by INCREASING the tax on numerous reinsurance related transactions. "What is especially unbelievable is that companies which were at the forefront of opening insurance markets in other countries to the U.S. Industry now want to take a protectionist view when their open markets and profits are at stake."*

Source: CICA Media Release, May 21, 2001

## Clarification of Exemption for P&C Companies – H.R. 1908

Jim Nussle (R-Iowa) introduced H.R. 1908 to increase the premium limits for the small property and casualty insurance elections under Section 501(c)(15) and Section 831(b). This bill would have increased the Section 501(c)(15) premium limitation on small property and casualty insurance companies from $350,000 to $551,000 for 2001, to be adjusted by the cost-of-living factor for later years. The bill would also have increased the premium limit for the alternative tax under Section 831(b) from $1.2 million to $1.89 million, adjusted annually for inflation.

## Exempt State-Created Organizations Providing P&C Coverage – H.R. 1789

E. Clay Shaw (R-Fla.) and co-sponsor Mark Foley (R-Fla.), introduced H.R. 1789 to exempt state-created organizations providing property and casualty insurance from tax if they offer insurance where it is otherwise unavailable. This provision would have exempted from tax certain entities created by the state prior to January 1, 1999, that provide property insurance in a state where there is no comparable coverage. These entities would have to meet certain qualifications for the tax exemption.

*During 2001, at least 40,000 income tax returns and $810 million in tax payments were lost from a Pittsburgh lockbox facility used to process tax returns and payments for the Internal Revenue Service. The IRS received at least 21,000 phone calls from taxpayers concerned about checks that did not clear.*

Source: BNA Daily Tax Report, August 31, 2001

## Former Insurance Agents Tax Equity Act of 2001 – HR 1134

H.R. 1134, Former Insurance Agents Tax Equity Act of 2001, would have modified the exemption from self-employment tax for certain termination payments received by former life insurance salesmen. Until 1997, insurance agents with certain termination requirements were subject to self-employment tax (SECA). The Taxpayer Relief Act of 1997 clarified that certain termination payments received by former agents are exempt from self-employment tax, but only allowed **eligibility** for termination payments to be tied to the agent's length of service. H.R. 1134 would have allowed the **actual payment amount** to be tied to length of service.

## Clarification of Treatment of Insurance Agents' Termination Payments

Sam Johnson, R-Texas, introduced H.R. 3139, calling it a "small business tax relief measure that will assist thousands of insurance agents throughout the country as they prepare for retirement." The bill, "Fair Tax Treatment for Insurance Agents' Termination Payments Act of 2001," was similar to H.R. 1134, "Former Insurance Agents Tax Equity Act of 2001," in that it sought to clarify or correct tax treatment of items specific to insurance agents.

## Who Wins?

***Wealthy Pay a Bigger Share…***
President Bush points out that people making more than $100,000 would actually pay a larger share of federal income taxes under his plan. Percent of income taxes paid by group:

| INCOME | CURRENT LAW | BUSH PLAN |
|---|---|---|
| Less than $10k | -0.9% | -1.1% |
| $10k-20k | -1.0 | -1.4 |
| $20k-30k | 2.2 | 1.9 |
| $30k-40k | 4.1 | 3.8 |
| $40k-50k | 5.4 | 5.1 |
| $50k-75k | 14.6 | 14.2 |
| $75k-100k | 13.6 | 13.4 |
| $100k-200k | 22.8 | 23.2 |
| $200k and up | 39.1 | 40.9 |

Source: Bush campaign

***But Get More Back…***
But the well-to-do would enjoy significant outs in their overall federal tax burdens, when employment taxes and consumer excise taxes are included, Effective tax rates:

| INCOME | CURRENT LAW | BUSH PLAN |
|---|---|---|
| Less than $10k | 9.8% | 9.7% |
| $10k-20k | 7.4 | 7.0 |
| $20k-30k | 12.2 | 11.4 |
| $30k-40k | 15.9 | 14.9 |
| $40k-50k | 17.3 | 16.2 |
| $50k-75k | 19.7 | 18.4 |
| $75k-100k | 22.1 | 20.8 |
| $100k-200k | 25.0 | 23.6 |
| $200k and up | 28.9 | 27.1 |

Source: Joint Committee on Taxation

Source: Wall Street Journal, February 8, 2001

The bill would have provided capital gains treatment for qualified termination payments received by former insurance sales agents. Termination payments often include payment for intangible assets such as the agent's "book of business" and goodwill. Congressman Johnson's bill would have defined a qualified termination payment as a payment received after termination of the agent's employment contract, whose amount depends on policies sold by the agent that remain in force after termination. The bill would have clarified that termination payments meeting the definition of a qualified termination payment are for the sale or other disposition of intangible capital assets and subject to capital gains treatment.

## "Terrorism Risk Protection Act" – HR 3210

Rep. Michael G. Oxley (R-Ohio) introduced H.R. 3210, which would have provided a reserve for terrorism coverage and would have ensured the continued financial ability of insurers to provide coverage for risks

from terrorism. The bill created a temporary industry risk sharing loan program to ensure the continued availability of commercial property and casualty insurance and reinsurance for terrorism-related risks. It began with taxfree "terrorism commercial business reserves" for amounts that are set aside for future unaccrued claims arising from declared terrorism losses; however, House taxwriters rejected the provision and instead replaced it with an amendment which provided for a study on the deductible reserve initiative.

> ***After the Sept 11 attacks, most insurance companies stopped offering commercial terrorism policies. Without it, banks won't make many commercial loans, including for real-estate projects. Lawmakers want to pass the legislation before the end of the year when about 70% of companies could lose terrorism coverage.***
>
> Source: Wall Street Journal. November 30, 2001. Michael Schroeder

When Democrats strongly objected to the House-passed version, the Senate released a draft version of legislation it intended to introduce. Under the draft legislation, the Federal Government would have provided 90 percent of insurance claims exceeding $25 billion in the first year and 80 percent in the second year. However, the proposed Senate bill, released just four days before Congress adjourned for the year, faltered in the Senate, where it failed due to partisan differences over whether victims should be allowed to sue U.S. businesses caught in the middle of an attack.[1]

## Economic Security and Recovery Act of 2001 – HR 3090

HR 3090, originally intended to stimulate an economy suffering in the wake of September 11, fell victim to Congressional in-fighting. The bill, first passed along party lines in the House, contained controversial business provisions including the complete repeal of corporate AMT, increased NOL carrybacks, special depreciation allowances, and a tem-

[1] Michael Schroeder and Christopher Oster, Wall Street Journal December 21, 2001

porary increase in expensing under Section 179. The Senate version contained a $66 billion Democratic proposal split almost evenly between tax cuts and aid for the unemployed and a tax relief package saddled with $15 billion in spending that Republicans called a deal breaker. After almost two months of deal-making and deal-breaking, Congress adjourned for the year without passing an economic stimulus bill.

> ***House taxwriters on November 16 unanimously rejected a permanent tax provision in the House terrorism risk protection bill that would have allowed insurance companies to stockpile funds in a tax-free reserve for future attacks. The panel voted to remove the tax language from the Terrorism Risk Protection Act (H.R. 3210) and replace it with an amendment from Ways and Means Committee Chair William M. Thomas instructing the Treasury to produce a study within four months on the deductible reserve initiative.***
>
> Source: TNT, November 16, 2001, 2001 TNT 223-2

## Victims of Terrorism Tax Relief Act – HR 2884

The events of September 11 caused a "United We Stand" fervor in the halls of government, and for a brief time, the parties of Congress banded together for the good of the Country. The unity soon subsided, however, and the only bill to pass Congress was the Victims of Terrorism Tax Relief Act, passed on the last day of the legislative year. The bill contains provisions for tax relief of those who died or were injured in the terrorist attacks on September 11, the Oklahoma City bombing, and bioterrorism involving anthrax before January 1, 2002.

## National Insurance Act of 2001

On the day before Congress adjourned for 2001, Senator Charles Schumer introduced legislation that would create an optional federal charter for the life and property and casualty insurance industries.

The bill would have provided for the creation of a new agency within the Treasury Department to charter, supervise and regulate national insurance companies and national insurance agencies. The agency would be headed by the National Insurance Commissioner, who would be appointed by the President and confirmed by the Senate.

The National Insurance Commissioner would be authorized to charter new National Insurance Companies, to approve the conversion of state insurers into National Insurance Companies, and to license underwriting activities. All National Insurance Agencies would be required to obtain a federal producers license, and state licensed producers would be able to sell policies issued by a National Insurance Company only if they hold a federal producer license.

> *After a partisan clash in the Senate Finance Committee left the panel polarized November 8, Democrats cleared without a single GOP vote a package of nearly $37 billion in tax relief in fiscal 2002 – the Finance Democrats' answer to an economy damaged by the September 11 terrorist attacks. But the plan was attacked by committee Republicans who charged that it was a Democratic "grab bag"of minor tax cuts and spending proposals that would do little to boost the economy. It squeaked by the committee on an 11-10 vote.*
>
> Source: Tax Analysts, November 8, 2001

## $3 Million Designated to Assist with Life Insurance Reserve Review

In addition to insurance tax legislation, Congress passed legislation giving new funds to the IRS in an effort to increase taxpayer compliance. Part of the funds related to life insurance reserve reviews.

*The Internal Revenue Service has shelved almost $12 billion in tax delinquencies since 1999 without further investigating the cases, the General Accounting Office told lawmakers May 8.*

*IRS collection activity reports showed that just over $2 billion in delinquencies had been shelved by September 1999, with the figure reaching almost $12 billion—including interest and penalties—by the end of March 2001.*

*For example, White said, from fiscal year 1996 to 2000, the number of IRS employees working collection cases in the field dropped from about 5,500 to about 3,600—about 35 percent. Some of this drop resulted from failure to replace employees who retired, and some resulted from reassignment of staff to work on customer service projects, according to the GAO testimony.*

*In addition, White said, GAO analysis shows that, over the same five-year period, the amount of time it takes to close a case, excluding offers in compromise, has increased by almost a third.*

Source: BNA Daily Tax Report, May 10, 2001

The IRS estimated an amount between $8 and $10 million relating to life insurance reserves is uncollected annually. The IRS believed this amount could be decreased with additional actuarial expertise or computer software.

In July, the House passed H.R. 2590, the Treasury-Postal 2002 appropriation bill. As part of this bill, the House Appropriations Committee instructed the Internal Revenue Service to spend up to $3 million for actuarial assistance and computer software relating to life insurance reserve reviews.

The final amount designated to the IRS in September by the Senate was $9.47 billion – approximately $9 billion more than the $3 million amount set aside for actuarial assistance and computer software. There were no changes in the amounts designated to the Treasury and the IRS.

# Chapter 3

## Reserves

In 2001 many high-profile companies shocked investors and Wall Street by announcing huge write-offs and charges to earnings, prompting questions about the validity of the 1990s bull run. Not unexpectedly, the IRS took careful note of reserve and other write-offs. The insurance industry was not exempt from scrutiny in matters of reserves.

One of the biggest reserve cases of the year was Physicians Insurance Company of Wisconsin[1] in which the Tax Court ruled that arbitrary increases to actuarially-determined point estimates were not reasonable. In addition to Physicians Insurance,[2] the IRS issued the first of two Technical Advice Memoranda on Section 832 loss reserves, and the Appeals Court affirmed the decision of the Court of Federal Claims in American Mutual.[3] Finally, the IRS issued Field Service Advice relating to the tax benefit rule, an Issue Settlement Program Guideline on changes in Section 807(c) reserves, and its second Technical Advice Memorandum regarding the use of graded valuation factors.

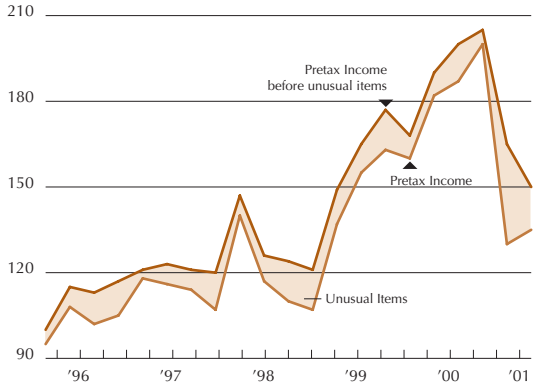
[1] *Physicians Insurance Company of Wisconsin, Inc. and Subsidiaries v. Commissioner* T.C. Memo 2001-304 (November 21, 2001)

[2] Ibid.

[3] *American Mutual Life Insurance co., etal. v. United States*, 88 AFTR 2d. 2001-6127 (October 3, 2001)

INCREASINGLY UNUSUAL

*The amount of unusual charges – such as restructuring expenses and write-offs of loans, equities and inventory – has soared in the most recently reported two quarters. Below is the pretax income before and after unusual items for the current group of Standards & Poor's 500 companies over the past five years. Quarterly figures are in billions.*




Source: Wall Street, Journal, July 17, 2001

## Deductible Unpaid Losses Limited

In *Physicians Insurance Company of Wisconsin, Inc. and Subsidiaries v. Commissioner*[4] the U.S. Tax Court found that the taxpayer incorrectly reported its undiscounted unpaid losses for purposes of computing its deduction for losses incurred. The case is an instance of good news, bad news. The good news is that the Court accepted the taxpayer's actuarially determined point estimates. This follows the 1998 ruling in Utah Medical[5] where the Court found that the taxpayer's reserves were reasonable in part because of the taxpayer's use of outside actuaries in setting its reserves. The bad news is that the Court, not surprisingly, did not accept what it determined were arbitrary and unsupported additions to reserves.

[4] T.C. Memo 2001-304

[5] *Utah Medical Insurance Association v. Commissioner*, T.C. Memo 1998-458

The taxpayer, Physicians Insurance Company of Wisconsin (Physicians), is a property and casualty insurance company whose predominant line of business is providing medical malpractice insurance for doctors and hospitals. During the years at issue, Physicians employed the firm of Tillinghast-Towers Perrin (Tillinghast) to perform all of its actuarial services, including estimation of its unpaid losses as part of its reserve reports. Tillinghast provided Physicians with point estimates of unpaid losses for the years in issue. Physician's treasurer and vice president of finances then selected an estimate of unpaid losses to recommend to the board of directors. Following approval by the board of directors, the unpaid losses were reported on Physician's annual statement. In both 1993 and 1994, Physicians' estimated unpaid losses were almost 10 percent higher than Tillinghast's estimates.

Coopers & Lybrand (C&L)[6] reviewed Physicians' 1993 and 1994 annual statements. Each year C&L actuaries and auditors reviewed Physicians' estimates of unpaid losses. In both years C&L nonactuarial auditors concluded that Physicians' unpaid losses on its annual statements exceeded the range suggested under C&L's in-house guidelines, but after further assessment determined that no unpaid loss adjustment was necessary for financial statement purposes. Additionally, Physicians retained the actuarial firm AMI Risk Consultants Inc. to review the 1993 annual statement unpaid losses. AMI concluded that the unpaid loss reserves were reasonable.

Physicians contends that because it reported the same estimates of unpaid losses on its annual statements and tax returns, and because it estimated these unpaid losses in a reasonable manner, using sound business practices, these estimates should be accorded deference for income tax purposes. The Tax Court disagreed with Physicians' arguments.

The Court argued that Physicians' "contention is at bottom a rehashing of long-rejected arguments that the Code reflects a congressional expectation that the estimates of unpaid losses used for tax purposes should conform to the precise figures shown on the annual statement." Rather, the Court noted that applicable regulations, Public Law, and numerous

[6] Now PricewaterhouseCoopers LLP

Appeals Court rulings give notice to the taxpayer that the Tax Code will be enforced by affirming the principle that taxpayers must prove their entitlement to deductions. Further, after hearing the opinions of expert witness from both parties, the Court concluded that Physicians "failed to establish that it made fair and reasonable estimates of its actual unpaid losses for the years in issue." Arguments that decisions to increase the point estimate were based on qualitative concerns, not actuarial estimates, were deemed unpersuasive and problematic.

This case is similar in many respects to the Tax Court ruling in Minnesota Lawyers Mutual Insurance Company[7] in which the Court concluded that reserves for unpaid losses and related loss adjustment expenses were unreasonable. The Court's decision was based on an abundance of bad evidence submitted by the taxpayer, including the fact that Minnesota Mutual showed redundancies over several years, although the company used an actuary to calculate its losses. Further, although Minnesota Mutual had used actuaries in making its estimates, the IRS concluded that the estimates were not fair and reasonable and did not represent petitioner's actual unpaid losses as nearly as they could be ascertained. Taxpayers should heed the message that the IRS will not simply accept statutory reserves as presented in the NAIC statement as a basis for tax reserves.

## Clarification Of Section 832 Unpaid Loss Reserves

### TAM 200115002

While the Physicians Mutual case broke no new ground, the IRS issued TAM 200115002, which clarified the IRS view of Section 832 unpaid loss reserves.

- **There is no difference between the standards set forth in Treasury Regulation 1.832-4(a)(5) and -4(b).** Under 1.832-4(a)(5), unpaid losses should "represent actual unpaid losses as nearly it is possible to ascertain them," while 1.832-4(b) requires that unpaid losses should "represent a fair and reasonable estimate." The difference

[7] U.S. Tax Court No. 21181-97, Memo. 2000-203

in language represents the differing focus between the method used by the taxpayer and what is required prior to an IRS adjustment under each provision of the regulations. The IRS concluded that if a reserve is "fair and reasonable," then the reserve is based on "actual unpaid losses as nearly as possible to ascertain."

- **The Treasury Regulation 1.832-4(a)(5) phrase "must represent actual unpaid losses as nearly as it is possible to ascertain them" is not considered to be a higher standard in estimating losses.** "As nearly as is possible" does not necessarily preclude the use of actuarial determined ranges. Instead it implies that the taxpayer should estimate reserves on actual losses rather than attempting to use an inflated version.
- **The term "fair" in "fair and reasonable" standard does not mean "more than reasonable."** The IRS has concluded that an unpaid loss estimate that would be considered "reasonable" would also be considered "fair." Therefore, adding "fair" to the term "reasonable" does not imply any other standard then reasonable.
- **The phrase "will be required to pay" does not mean that estimates must be the "most accurate" estimate.** The use of the word "will" rather than "might" relates to unpaid losses being based on actual rather than future losses. It does not imply that the estimates be the "most accurate."
- **The burden is on the taxpayer to prove that adjustments to unpaid losses are incorrect.** The IRS is not subject to the abuse of the discretion standard. The taxpayer may meet this burden by proving that their estimate is "fair and reasonable." This burden may not be met by comparing unpaid losses on the tax return to the amount on the annual statement.
- **Revenue Procedure 75-66 does not set forth any particular testing methodology.** Instead, it states that the "standard of reasonableness in computing unpaid losses will be set forth in Treas. Reg. 1.832-4(a)(5) and 1.832-4(b)."

- **Reserves are still considered "fair and reasonable" if later actual payments plus remaining reserves exceed original reserves.** Treasury Regulation 1.832-4(b) requires that estimates be made using information at hand. It concludes that the IRS must test according to "historical development analysis" rather than "hindsight analysis."

  The IRS also concluded that despite the fact that the taxpayer's asbestos and environmental unpaid loss liabilities were subject to contingencies, it did not prevent such reserves from being deductible as actual, not anticipated, incurred but not reported reserves (INBR.) Additionally, the IRS determined that a change in determining the method of accounting for A&E reserves from relying on managerial judgment to the use of an in-depth survey represents a "change in manner of calculating the estimate," rather than a change in accounting method.

> ***Lynn Turner, the SEC's former chief accountant, says the recent spate of write-offs of vendor-financed receivables raises troubling questions, though he declines to comment on specific companies. "I get very concerned when the accounting rules turn out an answer that just doesn't reflect the economics," Mr. Turner says.***
>
> Source: The Wall Street Journal, July 7, 2001

## Tax Benefit Case Affirmed

The tax benefit rule, a hotly debated topic was given some clarity this year in two rulings, one judicial, one technical. The rulings made it clear that, if in fact no tax benefit has been received, the tax benefit rule applies. Unfortunately for American Mutual,[8] the Court found that there had been a tax benefit. Nonetheless, this ruling provides an opportunity for other companies where no tax benefit has been received and years are still open.

[8] *American Mutual Life Insurance Co., et al. v. United States*, 88 AFTR 2d Par. 2001-5374

The Court of Appeals for the Federal Circuit affirmed a decision of the Court of Federal Claims, holding that a life insurer cannot assert the Section 111 tax benefit rule to exclude decreases in reserves from income, and concluding that a tax benefit had been received.

American Mutual claimed that it received no tax benefit from the net increases in reserves, and therefore should not have to include the subsequent reserve increases in income. It argued that in order to accurately determine whether the reserve increases in a previous year had any tax benefit, underwriting income would need to be recalculated as though there were no deductions for the reserve increases actually taken. American Mutual recalculated its underwriting income substituting previously unused dividend deductions for the reserve deductions taken. It concluded that its underwriting income was the same, the reserve deductions did not give rise to a tax benefit, and later corresponding reserve releases should not be taxed as income.

In its decision, the Court of Federal Claims concluded that since the reserve deductions reduced American Mutual's taxable income, the deductions did lead to a tax benefit and further noted that **had** there been no change in taxable income from the reserve deductions, that American Mutual's argument would have merit. However, because American Mutual realized a tax benefit for each dollar deducted, the court concluded that the tax benefit rule did not apply to American Mutual's reserve increases.

This issue, and its relationship to this case, is very complicated. The court was required to analyze, sort and prioritize the deduction of the tax reserve versus the deduction of the lost dividend received deduction, the three phase tax system in place at the time, and the ultimate conversion of that system to the current one. Sidestepping most of these issues, the ruling determined that American Mutual had received a benefit and therefore did not address the other issues.

## Taxpayer May Use Tax Benefit Rule for Settlement Proceeds

Following the American Mutual ruling, the IRS issued FSA 200145004,[9] supporting the comments of the Appeals Court in the American Mutual case, that, if in fact no tax benefit is received, the tax benefit rule will be applicable. The IRS concluded that a taxpayer may use the tax benefit rule to exclude settlement proceeds from income for years the taxpayer was tax-exempt.

Taxpayer[10] was a tax-exempt entity in years one through nine. In year ten, Taxpayer and State B initiated a lawsuit against an industry, which they eventually settled when several companies agreed to pay Taxpayer a certain amount of money over a five-year period. Taxpayer stated that settlement amounts were a recovery of losses incurred and litigation costs. Taxpayer asserted that the portion of the settlement relating to past years one through nine, when it was tax exempt, are excluded from income by the tax benefit rule.

Where subrogation recoveries relate to insurance losses deducted under Section 832(b)(5), even without a tax benefit, the IRS has traditionally taken the position that such recoveries do not come under the tax benefit rule because they are offsets to deductions, and not items of gross income. However, the IRS looked to "recent and unequivocal" judicial support for Taxpayer's exclusion of settlement proceeds and stated that it "would not litigate the issue in these cases again."

It is unclear how the results of these two rulings will impact those taxpayers arguing that tax benefit rule for Section 809 negative rate purposes.

[9] FSAs have not historically undergone the same level of review as private letter rulings (PLRs) or technical advice memorandums (TAMs), and therefore should not be relied upon as indicators of IRS position

[10] While it is not clear that the company in this FSA is an insurance company, the references to Section 832(b) would suggest so

The IRS issued reserve rulings on miscellaneous Section 807 issues such as the use of graded valuation interest factors to compute Section 807(d) reserves and reserve items treated as Section 807(f) basis adjustments. In addition, the IRS was called to explain a retroactively revoked closing agreement in Utica Mutual.[11]

***Revenue Ruling 2001-11: Applicable Federal Interest Rates for Purposes of Section 807***

| YEAR | INTEREST RATE |
|---|---|
| 1999 | 6.30 |
| 2000 | 6.09 |
| 2001 | 6.00 |

***Prevailing State Assumed Interest Rates***

**A.** Life Insurance Valuation:

| GUARANTEE DURATION (YEARS) | CALENDAR YEAR OF ISSUE (2001) |
|---|---|
| 10 or Fewer | 5.00 |
| 11-20 | 4.75 |
| 21 or More | 4.50 |

**B.** Single Premium Immediate Annuities and Annuity benefits involving life contingencies arising from other annuities with cash settlement options and from guaranteed interest contracts with cash settlement options:

| CALENDAR YEAR OF ISSUE | VALUATION INTEREST RATE |
|---|---|
| 2000 | 7.00 |

## Structured Settlement Reserve Computation

### TAM 200108002

The IRS concluded that the use of graded valuation interest factors to compute tax reserves under Section 807(d) was appropriate for structured settlements.

[11] *Utica Mutual Insurance Company and Subsidiaries v. Commissioner* of Internal Revenue

The taxpayer was a life insurance company that issued single premium immediate annuity contracts. It also issued annuities relating to structured settlements that would pay damages relating to wrongful death or injury. The annuities varied in the amounts that they paid out, due to such items as payment pattern and payout periods. For this reason, the taxpayer used a unique method of applying interest rates in computing statutory reserves.

Following the 1989 NAIC adoption of Actuarial Guideline IX-B, the taxpayer used the applicable prevailing State assumed interest rate under Section 807(d)(4) for single premium immediate annuities to compute its tax reserves under Section 807(d). For 1989 and 1992, the taxpayer changed its method of computing tax reserves to the same method it used for statutory reserves.

The IRS District Director questioned whether the use of a graded reserve method to compute tax reserves relating to structured settlement annuities issued between 1982 and 1987 was proper under Section 807(d)(2). It contended that Section 807(d)(2) required reserves for a life insurance or annuity contract issued prior to 1988 to be computed using the prevailing State assumed interest rate and that the taxpayer's use of multiple interest rates was incorrect.

The taxpayer argued successfully that their use of graded interest rates was correct and there was no guidance as to the treatment of structured settlement interest rates before the Guideline was issued. The IRS concluded that the use of graded valuation interest factors to compute the tax reserves under Section 807(d)(2) for structured settlement annuities issued was appropriate.

## Unpaid Losses Deficiency Challenged

Utica Mutual[12] filed a petition with the Tax Court arguing that the IRS ignored a previous Consent Agreement in issuing deficiency notices regarding Section 832 unpaid losses.

[12] *Utica Mutual Insurance Company and Subsidiaries v. Commissioner* of Internal Revenue

Utica Mutual incorrectly calculated discounted unpaid losses for 1987 through 1994. In January 1995, after realizing the error, Utica Mutual filed a Form 3115 "Application for Change in Accounting Method." Under a Consent Agreement, the IRS and Utica Mutual agreed that Utica Mutual would be required to take discounted unpaid losses into account in determining the amount of the losses incurred on a prospective basis. The Consent Agreement clarified that 1995 would be the year of the change and the Section 481 adjustment would take place over three years.

In January 1997, the IRS District Director made a request for a TAM regarding whether **1)** Revenue Procedure 92-20 applied to Form 3115, **2)** the Consent Agreement could be retroactively revoked, and **3)** whether the agent could impose the change effective to 1987 rather 1995. The TAM was issued in December of 1997. While it retroactively revoked the Consent Agreement, it bound "the Commissioner to the stated terms and conditions for effecting the accounting method change," but did not comment on the agent's request to make the change effective in 1987 rather than 1995.

In November 2000, the IRS sent Utica Mutual a deficiency notice regarding Section 832 unpaid losses for the years 1987 to 1994. Utica Mutual disagreed with these deficiencies, stating that the Consent Agreement allowed for the change effective 1995, along with the three-year Section 481 adjustment. Utica Mutual believes the IRS disregarded its own TAM, which would bind the Commissioner to the terms of the Consent Agreement.

It should be noted that although the TAM retroactively revoked the Closing Agreement between the IRS and Utica Mutual, it did maintain that the Commissioner was still tied to the *terms and conditions* under the accounting method change.

# Industry Specialization Program Coordinated Issue Settlement Program Guideline

The Industry Specialization Program (ISP) Coordinated Issue Settlement Program Guideline (Guideline) concluded that a change in Section 807(c) reserve items should be treated as a Section 807(f) basis adjustment, requiring amortization over ten years rather than a change in accounting method taken in full in the year of change.

The Examination Division's (Division) position is that a change in reserves under Section 807(c) not due to an error, is a change of basis and thus, subject to the 10-year spread under Section 807(f). This position is supported by Revenue Ruling 94-74, 1994-52 C.B. 157. Changes in reserve amounts due to corrections of nonrecurring or posting errors should be taken into account in the year they occur.

Additionally, the Guideline suggested that Appeals Officers examine two main issues when examining a proposed adjustment: **1)** verifying that the proposed adjustment resulting in a change in method is the difference between the ending reserves computed under the new method and ending reserves computed under the old method and **2)** establishing that the adjustment is proposed for the correct year.

Although the Guideline discussed the technical issue of a basis change, it failed to properly address the industry's concerns of the narrow application of a reserve error.

# Chapter 4

## Captive Insurance Companies

The courts and the IRS joined efforts to rule on many important captive insurance company issues during 2001. The IRS announced in a Revenue Ruling that it would no longer challenge captive insurance transactions based on the economic family theory, and the 11th Circuit Court of Appeals found in favor of the taxpayer in *United Parcel Service of America v. Commissioner*.[1] In addition, there were a number of IRS Field Service Advices (FSAs) released in 2001, which continued the IRS tradition of pursuing settlement—not litigation—in the captive arena. Although they provided no specific technical advice, the FSAs did apply the IRS decision to abandon the economic family theory.

[1] *United Parcel Service of America v. Commissioner* 87 AFTR 2d. 2001-2565 (June 21, 2001)

*While recent terrorist attacks in the United State might make captives a more attractive option for some risks, commercial buyers looking to self-insure might find it difficult to procure fronting companies, reinsurance, and service vendors, experts warn. "The business of captives has been gravely impacted by the event, and it seems that each new day we understand that impact even more," said Lisa Ventriss, president of the Vermont Captive Insurance Association.*

Source: National Underwriter: Property & Casualty/Risk & Benefits Management Edition. "Captive Services May be Harder to Find." McDonald, Caroline. 10/1/2001

## "Economic Family" Theory Abandoned Revenue Ruling 2001-31

The IRS issued Revenue Ruling 2001-31 stating that it will no longer use the "economic family" theory argument as a basis for disputing the legitimacy of captive arrangements. However, it will still consider capitalization and parent-subsidiary structures in determining the validity of captive transactions.

The IRS had previously determined in Revenue Ruling 77-316 that a taxpayer, its non-insurance subsidiaries, and its captive insurance company were considered one "economic family" relating to risk shifting and risk distribution. Thus, premiums paid within such unit were not deductible since the underlying contract did not meet the qualifications of risk shifting for insurance purposes. Since then, several courts have rejected this theory.[2]

This ruling breaks relatively little new ground. Although it is positive for the industry, the IRS has been backing away from the "economic family" theory for some time as demonstrated in several recent FSAs.[3]

[2] *See Humana, Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989) and *Kidde Industries, Inc. v. United States*, 40 Fed. Cl. 42 (1997)

[3] See FSA 200043008, 200043011, 200043012

## United Parcel Service

In *United Parcel Service of America v. Commissioner*,[4] the U.S. Court of Appeals for the 11th Circuit, in a 2-1 decision, sided with the taxpayer, finding that the taxpayer had sufficient business purpose to "neutralize any tax avoidance motive." The case was reversed and remanded to the Tax Court for consideration of the IRS's alternative arguments under Sections 482 and 845(a), which had not been addressed in the Tax Court's 1999 opinion (78 TCM 262).

Prior to 1984, UPS only reimbursed customers for lost or damaged parcels up to $100 in declared value, but customers had the option of paying an excess-value charge (EVC) to insure those packages in excess of $100. UPS processed and paid the resulting claims, and included in its taxable income all amounts from its EVC program. During 1983, UPS purchased an insurance policy from National Union Fire Insurance Company, under which National Union assumed the risk of damage to or loss of EVC shipments. UPS paid the EVCs it received from customers as premiums on the policy. At this time, UPS also formed Overseas Partners, Ltd. (OPL), a Bermuda company, and distributed the OPL stock as a taxable dividend to UPS shareholders. National Union entered a reinsurance treaty with OPL whereby OPL assumed risk commensurate with National Union's in exchange for premiums equal to the EVC payments made to National Union, reduced by commissions, fees, and excise taxes.

In coming to its conclusions, the Appeals Court addressed both economic substance and business purpose, which had been key contentions in the previous Tax Court ruling. The Appeals Court brushed aside the Tax Court's assignment of income analysis, stating that the issue in this case was "whether the excess-value plan had the kind of economic substance that would remove it from 'shamhood,' even if the business continued as it had before. Under the insurance policy, National Union was held liable for lost packages in exchange for the right to receive the EVCs. Because there was a "real insurance policy," the Appeals Court concluded that economic effect existed because there was the creation of genuine obli-

[4] United Parcel Service of America v. Commissioner 87 AFTR 2d 2001-2565 (June 21, 2001)

gations enforceable by an unrelated party. Although the higher court acknowledged that there was little change over time in how the EVC program appeared to customers, it found the Tax Court's notion of business purpose to be too narrow — "stretching the economic-substance doctrine farther than it has been stretched."

The higher court also found the UPS facts distinguishable from various precedents addressing the existence of a business purpose. In general, these other cases concerned either individual income tax returns, in which individuals sought to avoid taxes on income destined for personal consumption, or tax shelters, in which the transactions would not have occurred but for tax avoidance reasons. In contrast, the Appeals Court concluded that UPS's restructuring was consistent with other cases that succeeded in proving the existence of an adequate business purpose. As a result, the UPS transaction was found to do no more than alter the form of an existing bona fide business.

### *Dissenting opinion*

Dissenting, Judge Ryskamp argued that there was not a legitimate, substantive business reason for the transaction based on the evidence presented to the Tax Court, and "that this scheme was hatched with only tax avoidance in mind." He stated that National Union did nothing more than collect over $1 million in fees and expenses before passing the excess-value charge income to OPL, which was wholly owned by UPS shareholders.

It is unclear what effect this decision will have with respect to the issue of "control" because the court indicated that the risk on the EVC contracts was shifted to OPL in part because UPS did not legally own OPL. Additionally, while this case struck a significant blow to the IRS, it is unclear whether the Appeals Court's reasoning will be followed in other circuits.

*IES Industries Inc. et al. v. United States (87 AFTR 2d), represented a setback in the IRS's attempt to find an transaction a "sham transaction." The case, which dealt with a foreign withholding tax arbitrage strategy, demonstrated that a transaction may be respected if it contains some economic substance, despite the fact that it might have been tax motivated. The Eighth Circuit's opinions was divergent from Notice 98-5 in the treatment of foreign taxes as an expense. By examining whether an economic benefit was achieved, the Eighth Circuit ruled that the transaction did in fact have economic substance. The Eighth Circuit also determined the transaction had business purpose. The fact that the transaction had been structured to minimize risk was considered to be good business. The court stated: "A taxpayer's subjective intent to avoid taxes… will not by itself determine whether there was a business purpose to a transaction." It also added "The fact that IES took advantage of duly enacted tax laws in conducting the ADR trades does not convert the transactions into shams for tax purposes."*

Source: IES Industries Inc. et al. v. United States 87 AFTR 2d

## IRS Rulings

In a string of FSAs the IRS conceded several captive rulings. The common thread was a brother/sister structure with captive insurance premium and reserve deductions. These concessions are not surprising considering the long-standing judicial conclusion that a brother/sister relationship may provide the requisite risk shifting to be considered insurance, while a parent/subsidiary relationship generally does not. The IRS noted that factors to be considered in determining whether premiums paid to a captive are deducible include such items as whether the insured parties had true risk, the premiums charged were at market rate, the claims were established prior to payment being made, and the captive's business operations and assets were separate from the parent. Additionally, the IRS released one TAM which ruled that an insurance subsidiary which provides workers' compensation coverage for its sibling companies is an insurance company for tax purposes.

*Mr. Modecki, president of the Captive Insurance Companies Association saw immediate and profound effects from the terrorist attacks. He predicted, "I think you're going to see captives much more in the mix of considerations of corporations. I would expect that there are going to be a lot of inquiries to a lot of people about 'what is a captive and why should I consider a captive?' and people are going to seriously look at who they're doing business with in terms of the financial strength."*

Source: National Underwriter: Property & Casualty/Risk & Benefits Management Edition. "Terrorist Attacks Magnify Effects of Hardening Market." McDonald, Caroline. 10/1/2001

### FSA 200105014

The taxpayer deducted the premium amounts paid from it and its subsidiaries to its wholly-owned insurance subsidiary. The IRS initially disallowed these deductions, concluding that the transactions did not constitute "insurance." The IRS noted that the taxpayer did support a business purpose for the captive, with such items as no guarantees or "hold harmless" agreements. Additionally, the captive was considered adequately capitalized. The taxpayer suggested a settlement to the IRS in which deductions for payments from Parent to Insurance Subsidiary would be disallowed, while those from Subsidiaries be allowed. Ultimately, the IRS recommended conceding the premium payment deductions from Subsidiaries to Insurance Subsidiary.

### FSA 200125009

The Taxpayer, a domestic corporation, was the wholly-owned subsidiary of X, a foreign parent. X also owned Y, a registered domestic insurance company. Thus, Taxpayer and Y are sibling subsidiaries of a common parent. Y issued commercial general liability, products liability, and automobile liability policies for Taxpayer. Taxpayer deducted the amounts paid to Y for these premiums. The IRS did not disagree with the recommendation to concede the case.

### FSA 200125005

Taxpayer B was the wholly-owned subsidiary of C, the foreign parent of a number of subsidiaries. Taxpayer B filed a consolidated federal income tax return as the common parent of the U.S. affiliated group. C formed L, a wholly-owned insurance company that would issue global material damage/business interruption, global public/product liability, worker's compensation and employer's liability to both C and its subsidiaries. C contributed significant capital to L and upon formation, L was considered a brother-sister to Taxpayer B. Taxpayer B deducted the amounts paid to L. Taxpayers A and B held that the captive had been formed for a business purpose and that there had been no parental guarantees, comfort letters or letters of credits issued to L. L was also found to be amply capitalized.

The IRS did not believe that it would prevail and recommended that the brother-sister structure be conceded. While this FSA noted that no court had fully accepted the "economic family," it was decided prior to Revenue Ruling 2001-31 in which the IRS noted officially that it would no longer use the "economic family" theory in attacking captives.

### TAM 200149003

The IRS ruled that an insurance subsidiary that provides workers' compensation coverage for its sibling companies is an insurance company for tax purposes.

Insurance Subsidiary was originally incorporated to act as a reinsurer of the worker's compensation risks for its operating sibling corporations. Parent, its operating subsidiaries, and Insurance Subsidiary file a consolidated tax return. Because available coverage became unpredictable and premium costs were inconsistent, Parent established Insurance Subsidiary. Insurance Subsidiary's license only allowed it to provide reinsurance to the group's workers' compensation program.

In Year 8, Insurance Subsidiary was redomesticated and became a fully licensed insurance company. It began writing insurance policies for the operating subsidiaries within the group and has not assumed any new reinsurance business.

In ruling that Insurance Subsidiary is an insurance company for tax purposes, the IRS considered that there were no parental or related party guarantees. The company was adequately capitalized and its premium to surplus ratio was strong. The reason for the formation of the company was due to significant disruptions in the price to be paid to unrelated insurers for workers' compensation coverage. Further, Insurance Subsidiary was a fully regulated, non-captive, domestic insurance company which issued separate policies and maintained separate records apart from its affiliates. Finally, Insurance Subsidiary assumed the workers' compensation risks and distributed the homogeneous, independent risks among its insureds. To some extent Insurance Subsidiary reinsured those risks with a large unrelated insurance company.

## Guidance for Appeals Officers Relating to Captive Insurance Companies Industry Specialization Program (ISP) Coordinated Issue Settlement Program Guideline

Midyear, the IRS released ISP Guidance pursuant to a suit filed by Tax Analysts, in which the IRS was required to make such documents public. Of particular interest to insurance companies was a Guideline which provided guidance to Appeals Officers regarding settlements relating to captive insurance companies. Although the Guidance was 10 years old on release—and further outdated with the release of Rev. Rul. 2001-31—it is still an indicator of the items the IRS would consider during its appeals process relating to captives.

The ISP Guidance discusses the basics of captive insurance as well as the tax benefits of such arrangements. The IRS's position regarding captive insurance was that a taxpayer had not purchased insurance when it paid premiums to an entity that it owned (either directly or indirectly) and therefore was ineligible for a deduction. The "economic family theory" as well as the use of unrelated business was available to the IRS to attack captive insurance arrangements it felt were invalid.

The Guidance also discusses important issues found in captive insurance cases such as the deductibility of premiums paid by a parent to a captive subsidiary, the deductibility of premium payments paid by one subsidiary to a captive within the group, and the deductibility of premium payments to a captive owned by a group of unrelated parents.

Finally, the IRS recommends the use of a closing agreement in all cases in which there is a partial concession by the IRS or full concession by the taxpayer regarding deductibility of premium amounts paid to a captive insurer.

## DOR v. Gatsby Industries

With captive insurance companies high on the Federal radar, the Illinois Department of Revenue (DOR) concluded in an administrative decision [5] that a Vermont captive insurance company that was not considered an insurance company for federal purposes was not an insurance company for Illinois state purposes. Thus, the company must be included in the parent's unitary group.

Gatsby Industries (Gatsby) formed Pennybacker Insurance Co. (PIC) as a captive under the laws of Vermont. Gatsby filed an Illinois unitary tax return for 1992 - 1994, excluding PIC. PIC filed a Vermont captive return and paid premium taxes to the state. Gatsby contended that since PIC was an insurance company under Vermont law, it should not be included in the unitary return and that by not considering a Vermont captive to be an Illinois captive would violate the Uniformity Clause of the Illinois Constitution of 1970. The administrative judge ruled that not being considered a federal insurance company prevented filing as an Illinois captive: "If the Internal Revenue Service determines that it is not valid entity for federal income tax purposes, it will not be recognized for Illinois income tax purposes."

[5] DOR v. Gatsby Industries Inc. IT 00-10 (May 16, 2000)

# Chapter 5

## Reorganizations

The much-anticipated mergers following the 1999 passage of the Gramm-Leach-Bliley Act still did not materialize in 2001. In fact, the Citibank-Travelers merger showed signs of disappointment when news of a spin-off of its P&C insurance business leaked in late 2001. The merger between Citibank and Travelers was a much-touted combination expected to create efficiencies through the cross-selling of all insurance products. However, in mid-December it was disclosed that although Travelers is one of the nation's largest and healthiest property-casualty insurers, it has posted a lower growth rate than other units of Citigroup.[1] The spin-off is expected to happen early in 2002.

[1] Beckett, Paul. The Wall Street Journal. December 19. 2001

Merger litigation initiated by the IRS in addition to important Field Service Advice and several smaller rulings on demutualizations and 831(b) elections kept insurance companies and reorganizations in the news. Nonetheless the reorganization area is full of tax uncertainties for insurers.

Perhaps the most important development in the area of reorganizations was the release of a Field Service Advice in which the IRS concluded that a life insurer may determine basis in a reinsurance ceding commission by using the Section 338 residual allocation method. Contrary to 338(h)(10) regulations which, when issued last year, indicated that fixed asset acquisitions were to be treated as assumption reinsurance, in the case of the acquisition of substantially all of the assets of a seller's business, the IRS ruled that the purchase price allocation rules under Sections 338(b) and 1060(a) would apply.

In one of the most surprising decisions of 2001, the Circuit Court of Appeals reversed the Court of Federal Claims ruling in *Rite Aid Corp. v. United States*.[2] The Court of Appeals ruled that the IRS went beyond the mandate of its authority in a Treasury Regulation which imposed tax on items that would not normally be taxed. Another important case, *Pioneer Hi-Bred International*,[3] came before the Federal Circuit Court which ruled that disclosure of tax consequences of a merger in an SEC proxy statement waived attorney-client privilege for the underlying documents.

In addition to these significant court cases, the IRS issued several Private Letter Rulings discussing demutualization and Section 831(b) election revocations. On the whole, these rulings signalled IRS willingness to give demutualizations tax-free treatment and to allow 831(b) election revocations where there is a significant change in business.

[2] *Rite Aid Corp. v. United States*, 225 F. 3d 1357 (July 6, 2001)

[3] In re Pioneer Hi-Bred International, Inc. 238 F.3d 370 (February 5, 2001)

# Section 338 Residual Allocation Method

**FSA 200144028**

In a significant Field Service Advice, the IRS concluded that a life insurer may determine basis in a reinsurance ceding commission by using the Section 338 residual allocation method instead of the Treas. Reg. 1.817-4(d)(2) reserve method. The Section 338(h)(10) regulations indicate that an acquisition involving an insurance company should be treated as an assumption insurance transaction.

The Taxpayer, a life insurance company, acquired a portion of the business of Seller for cash. Taxpayer acquired 100% of the stock of certain Seller subsidiaries and investment assets. Additionally, through an indemnity reinsurance agreement, Taxpayer assumed 100% of the contract liabilities relating to a block of Seller's existing policies. Taxpayer paid Seller a ceding commission based on an estimate of future statutory profits on the policies assumed. Seller transferred an amount of investment assets equal to the statutory reserves for the policies and the right to all future premiums on the policies.

Taxpayer reported the acquisition of its portion of Seller's business, including assets acquired through the indemnity reinsurance agreement, on its federal income tax return. Taxpayer reported the aggregate fair market value of the assets in appropriate classes and included the ceding commission in asset Class IV as a 197 intangible. Taxpayer allocated the total consideration among each asset class in accordance with the residual method specified in Sections 338(b) and 1060(a). Taxpayer included the net positive consideration from the indemnity reinsurance agreement in its net premiums for purposes of determining the amounts capitalized as specified policy acquisition expenses.

The agent suggested applying the principles of Treas. Reg. 1.817-4(d)(2) to redetermine the amount incurred as an indemnity reinsurance ceding commission. Nevertheless, the IRS concluded that if Taxpayer had simply reinsured the policies in a conventional reinsurance transaction, the ceding commission would be determined in accordance with the principles

of Treas. Reg. 1.817-4(d)(2), relating to assumption reinsurance contracts. However, since Taxpayer acquired substantially all of the tangible and intangible assets associated with Seller's business, the purchase price allocation rules under Section 1060(a) would apply. The IRS cited Congressional approval of Sections 1060 and 197 in concluding that "application of the principles of Treas. Reg. 1.817-4(d) to determine the amount of Taxpayer's basis in the indemnity reinsurance ceding commission would not be appropriate where… the reinsurance agreement was part of a taxable acquisition of a going business to which the rules of section 1060 would apply." Further, the IRS argued that the principles of Treas. Reg. 1.817-4(d)(2) were designed for conventional reinsurance transactions and not for acquisitions of whole businesses with various categories of intangibles.

In a previous ruling, the IRS determined that the portion of a deemed asset sale represented by the purchase of existing insurance policies should be treated as assumption reinsurance (see FSA 200018004), implying that to the extent noninsurance assets are also transferred, the transaction would be bifurcated.

## Attorney-Client Privilege Waived

The Federal Circuit Court ruled in *Pioneer Hi-Bred International* [4] that the disclosure in an SEC proxy statement of the tax consequences of a merger waived the attorney-client privilege for the underlying documents. The waiver was considered to apply to all documents that "formed the basis for the advice, all documents considered by counsel in rendering that advice, and all reasonably contemporaneous documents reflecting discussions by counsel or others concerning that advice."

The issue arose from a breach of contract case between Monsanto Company and Pioneer Hi-Bred International (Pioneer). Monsanto attempted to obtain information regarding the tax consequences of the merger and Pioneer challenged those requests, citing attorney-client privilege.

[4] *In re Pioneer Hi-Bred International, Inc.* 238 F. 3d 370 (February 5, 2001)

Monsanto countered that since the merger items had already been released into the proxy statement, as required by the Securities and Exchange Commission, they were not eligible for such privilege.

The District Court ruled that the merger information was not privileged since the information would eventually be released publicly. Monsanto filed in Federal Circuit court to overturn the District Court's ruling.

The Federal Circuit Court considered this case to be an extension of *United States v. Cote*,[5] stating that in Cote the privilege arose from the "substance of a communication" and "not to the particular words used." Therefore, the taxpayers had "effectively waived the privilege not only to the transmitted data but also as to the details underlying that information." Additionally, the disclosure of advice regarding the tax consequence of a merger would lead to waiver of privilege for all documents used in forming that advice, as well as related document discussions.

Companies should be mindful of this case as they prepare their SEC filings and consider what privilege they may be giving up through proxy disclosure.

***Reinsurers and Banks:*** *"Investment banks in particular possess top-notch distribution channels with direct access to the capital markets, principally through their long-standing relationships with institutional investors. For the majority of reinsurers such access is either transitory or relatively recent. What banks lack, of course, is underwriting expertise. When investment banks Goldman Sachs and Lehman Brothers entered the reinsurance market three years ago, through the capitalization of Arrow Re and the establishment of Lehman Re respectively, it was forecast that the new bank-owned Bermudian enterprises would take away considerable business from the so-called traditional reinsurers. This has not happened to any great extent, but, with Lehman Re in particular, global insurance and capital markets have been brought together to a significant degree."*

Dow Jones & Company; World Reporter November 9, 2000

[5] 456 F. 2d 142 (8th Cir. 1972)

## Rite Aid

In *Rite Aid Corp. v. United States*,[6] the Court of Appeals for the Federal Circuit reversed a decision by the Court of Federal Claims which stated that Treas. Reg. 1.1502-20 was "not arbitrary, capricious or manifestly contrary to law." Instead, the United States Court of Appeals for the Federal Circuit concluded that the duplicated loss factor was not within the authority delegated by Congress under Section 1502. The courts have normally been willing to give deference to regulations. However, here the courts ruled that a regulation went beyond the mandate of its authority.

In 1984 Rite Aid acquired 80% of Penn Encore (Encore) in a $3 million asset sale. The remainder of the Encore stock was purchased in 1988 for $1.5 million. Encore was included in the Rite Aid consolidated group from 1984. Due to declining sales, Rite Aid sold Encore to third-party CMI Holding Corp. (CMI), in a transaction in which a Section 338(h)(10) election was not taken and a net loss calculated.

Although Section 165 would allow Rite Aid a deduction for this loss, under Treas. Reg. 1.1.502-20 a shareholder's investment loss is disallowed to the extent of the subsidiary's duplicated loss factor. This factor is calculated as the excess of the subsidiary's adjusted basis over its asset's value after the sale. Since Encore's duplicated factor was larger than Rite Aid's investment loss, Rite Aid's deduction was disallowed.

The case was heard in the U.S. Court of Federal Claims and focused on whether Treas. Reg. 1.1502-20 was "a proper exercise of the Secretary of the Treasury's regulatory authority." In claiming that it was, the Federal Claims Court denied Rite-Aid's motion for a refund despite Rite-Aid's argument that Treas. Reg. 1.1502-20 taxes items that would not normally be taxed.

[6] *Rite Aid Corp. v. United States*, 225 F.3d 1357 (July 6, 2001)

In examining whether the Secretary had authority regarding Treas. Reg. 1.1502-20, the Court of Appeals for the Federal Circuit noted that "A regulation is manifestly contrary to the statute if it is outside the scope of authority delegated under the statute." The Court of Appeals also mentioned that the legislative history of the consolidated regulations records that the purpose of Section 1502 was to allow the Secretary to identify and correct tax avoidance regarding consolidated returns. However, it did not permit the Secretary to choose a method that would impose tax on income that was not otherwise taxable.

The Court of Appeals concluded that "rather than creating symmetry in the tax code, then, the duplicated loss factor distorts rather than reflects the tax liability of consolidated groups and contravenes Congress' otherwise uniform treatment of limiting deductions for the subsidiary's losses. Because the regulation does not reflect the tax liability of the consolidated group, the regulation is manifestly contrary to the statute."

*There were 26 major acquisitions in the life insurance industry alone from 1997 to 1999. But acquisitions are a double-edged sword: with this newfound M&A ability comes the risk of hostile takeovers, which may require management to take strong action, such as laying off personnel. In fact, according to A.M. Best, demutualized insurers cut their workforce by 40 percent, on average, after restructuring.*

Source: Mutually Assured Survival, Anatoly Bushler, Jason Hanleybrown, Julian Lighton, Robert T. Uhlaner, p.158

## Demutualizations

The IRS considered three reorganizations of mutual life insurance companies into stock corporations to be Section 368(a)(1)(E) tax-free recapitalizations. These rulings confirmed the IRS's previous tax-free treatment of demutualizations where effected for a valid business purpose. Among others reasons, the IRS considered demutualizations tax-free recapitalizations if the mutual insurance company represented that shares issued approximately equaled the value of the membership interests surrender

for them; there were no plans to redeem the stock issued in the conversion; there were no convertible rights on the stock issued; and the conversion was not part of a plan to increase the proportionate interest of any policyholder. The letter rulings also confirmed the IRS's tax-free treatment of demutualizations.

In addition to ruling on the tax-free recapitalization, the IRS also ruled on the basis of company membership interests, the holding period of the company stock received in exchange for membership interests, effective date of the company's life insurance or annuity contracts issued, and whether there would be a gain or loss on the exchange of membership interests.

> ***Mutual's business returns as a percentage of total assets are low and declining. They must look for new business opportunities. Besides capital, plenty of mutual insurers have other underutilized assets such as strong brands and large customer bases that can easily be leveraged into new growth businesses.***
>
> Source: Mutually Assured Survival Anatoly Bushler, Jason Hanleybrown, Julian Lighton, Robert T. Uhlaner, p.161

### LTR 200111013

The IRS considered the reorganization of a mutual life insurance company into a stock corporation to be a Section 368(a)(1)(E) tax-free recapitalization.

Company was a mutual life insurance company and the parent of an affiliated group. Company owned all the stock of Holding Sub 1, which owns Sub 1. For valid business reasons, Company will convert from a mutual life insurance company to a stock life insurance company.

### LTR 200114002

Company was a mutual life insurance company and the common parent of an affiliated group that filed a life-nonlife consolidated federal

income tax return. Company would contribute capital to New Parent, in exchange for New Parent voting stock. Company would then demutualize and issue its shares of voting stock to New Parent in exchange for New Parent stock that will later be extended to policyholders. All membership interests will be disbanded and policyholders will be eligible to receive New Parent stock for their membership rights. The New Parent will issue additional stock on the open market on as part of an IPO. As a result, the new stock life company will be owned by the new and publicly traded parent.

### LTR 200144001

Holding is a mutual life insurance holding company and the common parent of an affiliated group that has elected to file consolidated returns. Holding will reorganize into New Company 1 as Holding's wholly-owned subsidiary. New Company 1 will organize into New Company 2, as New Company 1's wholly-owned subsidiary. Holding will become a stock corporation by completing an administrative procedure under state law. Holding will merge with New Company 2 in a forward triangular merger. Holding's subsidiaries will also merge into New Company 2. As consideration for the termination of their deemed stock interests in Holding, members will receive New Company 1 common stock, cash, or policy credits. New Company 1 will hold a public offering to raise capital which it will contribute to the insurance company.

## Section 831(b) Election Revocations

The IRS issued three rulings regarding Section 831(b) election revocations, all of which were granted. In PLR 200142014, the IRS granted revocation going forward, but denied revocation for a previous tax year. The IRS Commissioner, who must approve a Section 831(b) election revocation, noted that the purpose of the election, as stated in legislative history, is simplification, not tax elimination. IRS conclusions highlighted the need to review carefully the characteristics of each party to a reorganization, the timing of the transaction, and future operations. In addition, the rulings demonstrate some of the factors the IRS examines in deciding

whether to revoke an election. A taxpayer must show that there has been a change in the character of its business, which may include factors such as historic profitability margin, significant changes in amounts of premiums written, reinsurance strategy, and available geographic area. Simply having a higher tax liability with the election is insufficient for revocation. However, the IRS demonstrated its willingness to grant revocation when the taxpayer proves that the character of its business has changed significantly.

### PLR 200121040

The taxpayer was a small mutual insurance company taxable under Section 831, providing property and casualty insurance for homes, farms, and farm buildings. At the time it made the election, the taxpayer was a county mutual insurance association that could only write premiums in the county in which it was located and any adjacent county. The taxpayer also relied upon reinsurance to protect against losses.

In year 7, the taxpayer acquired the assets of another county mutual insurer and adopted new articles of incorporation, increasing its area in which it could write insurance. The company also retained and managed more customer risk, reducing its reliance on reinsurance. After the merger, the taxpayer's margins between premiums charged and losses narrowed due to economic pressures in the agriculture economy. The taxpayer's tax liability was greater than if the Section 831(b) election was not in effect. Premium volume since the merger also tripled. The IRS granted revocation.

### PLR 200133020

The taxpayer, a small mutual insurance company under Section 831, provided a variety of policies within State A. The taxpayer primarily wrote fire and allied lines within a six county area, covering risks in the $0 - $20,000 range. The taxpayer was heavily reliant on quota share reinsurance. In Year 11, the taxpayer acquired the assets of Target, another statutory mutual insurance association, in a statutory merger. After the merger, policies were written within a larger area of the state and

increased in amount from $50,000 - $500,000. The taxpayer also relied less upon reinsurance. Recently, the taxpayer suffered several years of underwriting losses and demonstrated that its tax liability was larger than if the election had not been in effect. Revocation was granted.

### PLR 200142014

In PLR 200121040, a taxpayer was given permission to revoke its Section 831 election for the 2001 tax year; however, the request for revocation of election for the 2000 tax year was denied.

The taxpayer was a small insurance company whose principal business activity was the sale of fire, wind, and inland marine insurance contracts with written premiums of less than $1,200,000. Toward the end of the 2000 tax year, Taxpayer entered into a type A reorganization. Taxpayer anticipates that in tax years subsequent to 2000, its annual written premiums will exceed $1,200,000. At that point, its election under Section 831(b)(2)(A)(ii) will automatically terminate.

Taxpayer requested a consent to revoke its election under Section 831(b)(2)(A)(ii) effective for the 2000 tax year both to utilize Target's net operating losses and to ease administrative burdens that would arise if revocation was not granted. Because the merger of Target into Taxpayer occurred in 2000, Target's net operating losses carryover to Taxpayer in 2000. However, if Taxpayer is taxed under Section 831(b) in 2000, Taxpayer will be prohibited from utilizing those net operating losses subsequent to 2000. The IRS denied revocation for the 2000 tax year, citing concern that a primary motivation in seeking the revocation was as a means of eliminating tax liability through the use of Target's net operating losses.

### ILM 200138014

In contrast to the Section 831(b) revocations permitted in three Private Letter Rulings, the IRS concluded in a legal memorandum (ILM) that it would be impermissible to utilize a net operating loss (NOL) carried forward from a Section 831(b) tax year to a Section 831(a) tax year due to reorganization.

Taxpayer was a small mutual insurance company taxable under Section 831. From Year 1 until May 21, 2001, when the election was revoked, it had elected to be taxed only on its investment income. The Target was a small mutual insurance company that had not made a Section 831(b) election and was not exempt under Section 501(c)(15). From Year 1 through Year 10, Target had operating losses. The survivor of the merger, Taxpayer, kept its election under Section 831(b) and obtained the carry-over of NOLs in a year in which it was subject to Section 831(b). Section 831(b)(3)(A), does not permit an NOL to be carried forward from a Section 831(b) electing year to a Section 831(a) electing year. Therefore, the IRS concluded that would be impossible for the Taxpayer to utilize the NOL.

# Chapter 6

## International Developments

One of the key items arising in the international arena was the ratification of the new U.S./U.K. tax treaty which would replace the original treaty signed in 1975 and last amended in 1979. This new treaty added an "anti-conduit" rule regarding excise taxes on insurance premiums, as well as an unprecedented zero withholding rate on dividends paid between residents of both countries.

Additionally, the Organization for Economic Cooperation and Development (OECD) was in the news again, most notably for an extension of the deadline to publish the list of uncooperative tax havens. The events of September 11 may also create more pressure for the OECD to require more reporting and crack down on nations considered to shelter dubious income. One result of the crack down on tax shelter nations was the information exchange agreement signed between the United States and Antigua and Barbuda at year end.

Finally, the IRS issued new final and proposed regulations pertaining to certain annuity contracts issued by insurance companies, rules for new withholding for financial institutions, and requirements for excise tax returns, payments, and deposits. And, courts in Canada and the Netherlands issued significant rulings on insurance-related cases in those countries.

# United Kingdom

The new U.S./U.K. tax treaty, which was signed into law on July 24, 2001, contains a number of provisions remarkable for their singularity. This is the first US income tax treaty to provide a zero rate of withholding tax on dividends from subsidiaries. The new treaty is also the first time the United States and the United Kingdom have written a double tax treaty with an article for comprehensive limitations on benefits. Also included in the new treaty are provisions relating to excise taxes, interest withholding, and pensions and retirement benefits.

## *Excise Taxes*

While most other countries with which the U.S. has agreements or treaties contain an "anit-conduit" rule, the previous U.S./U.K. treaty did not and, in fact, allowed for a full exception regarding the elimination of U.S. excise tax on the reinsurance of premiums to the U.K. The new treaty will disallow the excise tax exemption for risks ultimately reinsured outside of the U.K. In those cases, any reinsurance of U.S. risks to related or unrelated parties outside of a country with a treaty that exempts excise tax will cause U.S. excise tax to be triggered on that activity.

This provision presently prevents treaty shopping and makes the taxpayer liable for the excise tax, but the IRS must first track the reinsurance to its ultimate destination. As a practical matter, the liability for the excise tax can be contractually assigned by any party; however, the company within the U.S. is liable for the tax. Companies may wish to consider entering into a closing agreement with the IRS in order to assign the liability to the foreign company.

## *Direct Investment Dividends Withholding*

The normal rule of dividends would apply, with withholding on direct investment dividends—those paid by a corporation to a recipient that holds more than 10% of the voting power—at 5%. The withholding rate for other dividends is 15%.

It is interesting to note, however, that the provision allows dividends paid by one resident of a country covered by the treaty to the beneficial owner of a resident of the other country covered by the treaty, and that meets certain qualifications, to have no withholding. This is unprecedented in U.S. treaty policy and may put pressure on other U.S. treaties that currently withhold on such dividends.

### *Interest Withholding*

Contingent interest or "excessive" interest paid relating to certain securitization arrangements would not be exempted from withholding.

### *Pensions and Retirement Benefits*

Overall, the treaty respects both countries' accepted pension and retirement plans. When an individual of one treaty country participates in the pension plan of another participating country, pension payments are taxed according to the individual's residency.

If an employee receives employee stock options and has performed services in both countries between date of grant and excise, "the country in which the employee is not resident may tax only that proportion of the option gain which relates to the period between the dates of exercise and grant during which the employee was providing services in that country."

### *Limitations on Benefits*

The treaty designates that only "qualified persons" are eligible for treaty benefits.

Qualified persons are designated as:

- Companies publicly traded on the treaty-recognized stock exchanges and their subsidiaries
- Pensions and charities if more than 50% of the beneficiaries are residents of either country

- Companies with respect to which seven or fewer "eligible persons" own at least 95% of the voting power of the company
- Companies engaged in substantial trade or business in one of the countries (but only to the extent of income connected to the trade or business), and
- Companies determined to be qualified on a discretionary basis by the competent authority of the other Contracting State

> ***The Treasury Department is continuing to study whether Section 482 regulations can effectively prevent multinational insurance companies from improperly shifting income from the United States to Bermuda, Deputy Treasury International Tax Counsel (Treaty Affairs) Patricia Brown said Oct. 13.***
>
> Source: BNA Daily Tax Report, October 18, 2000

## OECD "Tax Haven" List Postponed

The OECD began the new century with a January 7 meeting between countries blacklisted for harmful tax practices and members of the IMF, World Bank, the Caribbean Community, and financial institutions from Canada, the United States, and Great Britain. The meeting was the first opportunity for the OECD to meet with nations targeted as tax havens, and the OECD had hoped to use the meeting to make progress toward its goal of removing harmful tax practices by 2003. Despite an early start, however, on July 31, the Secretary General of the OECD, Donald J. Johnston released a statement that officially postponed the deadline for retaliations imposed for harmful tax practices. The deadline had been set in the June 2000 report "Towards Global Cooperation."

The report listed 35 nations that had not cooperated with the attempt to remove harmful tax practices and gave the countries on the list a one-year grace period to reform. Since the OECD has no enforcement mechanisms, sanctions would instead be imposed by the 29 member states. Due to the deadline change, there will be no sanctions imposed until

April 2003 at the earliest. It was anticipated that sanctions would begin against "uncooperative" tax haven jurisdictions by July 31, 2001.

The OECD-Commonwealth Joint Working Group of Harmful Tax Competition also responded to questions from "tax havens" regarding the agreement the OECD would like them to sign. The answers demonstrated the direction the project would be taking. It would focus more on the exchange of information rather than the lowering of individual nation's tax rates. If a jurisdiction commits to work with the OECD, it will have 12 months to develop a plan to be in place by December 31, 2005. The member countries themselves will commit to removing their "harmful" jurisdictions by the earlier date of April 2003.

**Paul O'Niel**

**The Treasury Secretary, a foe of anti-money-laundering laws earlier this year, now sees need for them**

| BEFORE | AFTER |
|---|---|
| For large nations to sanction small ones for not sharing banking information "is, by its nature, highly coercive." | "We have to hunt the financial benefactors and the wilfully blind financial intermediaries that underwrite murder and mayhem." |

Source: Time Magazine, October 22, 2001

While the executive branch, the Senate, and the OECD concentrated on a new treaty and harmful international tax practices, the IRS issued new final and proposed regulations in three separate areas. The IRS issued proposed regulations pertaining to certain annuity contracts issued by insurance companies and a Notice containing special rules for new withholding for financial institutions, including insurance companies. In addition, the IRS issued final regulations on the requirements for excise tax returns, payments, and deposits, effective for calendar quarters beginning September 30, 2001.

*Close to $9 billion in new insurance capital has been raised in Bermuda since the Sept. 11 terror attacks, with the latest contributions from three U.S. companies making this British offshore tax haven one of the richest insurance markets in the world. Since the 1960s, Bermuda has developed an insurance and reinsurance market with capacity now greater than that of Lloyd's of London. Bermudian companies provide 30 percent, the largest block, of Lloyd's total capacity. In recent years, some 1,500 companies in Bermuda have been taking in more than $20 billion in premiums a year, making it a major force in the industry.*

Source: Associated Press Newswires; Dow Jones & Company November 8, 2001

## Proposed OID Exception for Foreign Insurance Annuities

The IRS issued proposed regulations, providing guidance as to whether certain annuity contracts issued by insurance companies would be excluded from the definition of a debt instrument under the original issue discount provisions.

Section 1275(a)(1)(B)(ii) excepts annuity contracts to which Section 72 applies under certain circumstances if the contract is issued by an insurance company subject to tax under subchapter L. The proposed regulations provide that an annuity contract issued by a foreign insurance company would be treated as issued by an insurance company subject to tax under subchapter L if the insurance company is subject to tax under subchapter L with respect to income earned on the annuity contract.

An annuity contract issued by a foreign insurer without a U.S. trade or business or without a U.S. permanent establishment under a tax treaty will not be excluded. However, if the annuity is purchased from the insurer's U.S. trade or business, the exclusion will apply.

*On December 27, 2001, the IRS released a letter from American Council of Life Insurers discussing the difficulties of the new information reporting requirements for payments made overseas by life insurance company subsidiaries. The letter describes the issues and suggests that the current rules be suspended until such time as appropriate modifications can be made.*

Source: BNA Tax Core. December 27, 2001

## Withholding Rules for Payments to Financial Institutions in U.S. Possessions

Notice 2001-11 contains special rules under the new withholding regulations for financial institutions organized under the laws of a U.S. possession (possessions financial institutions).

Possessions financial institutions acting as intermediaries will not be treated as nonqualified intermediaries under the new Section 1441 regulations. Thus, these entities will be treated as a U.S. branch under Treas. Reg. 1.1441-1(b)(2)(iv) and may agree with a withholding agent from which it is receiving payments to be treated as a U.S. person.

The Notice contains the following guidelines:

- Payments of U.S. source income to a possessions financial institutions that agrees to be treated a U.S. person will be treated as made to a U.S. payee and therefore not subject to withholding under Section 1441.
- The possessions financial institution shall be subject to all of the withholding and reporting obligations of a U.S. withholding agent.
- A possessions financial institution that agrees to be treated as a U.S. person must provide a withholding agent with a properly completed Form W-8IMY on which it evidences its agreement to be treated as a U.S. person. The possessions financial institution should not provide a Form W-9.

- A withholding agent making a payment to a possessions financial institution that agrees to be treated as a U.S. person must report payments made to the institution on Form 1042-S.

> *Tax Havens are one of the World's great growth industries. And the amount of money they harbor around the globe is staggering—as much as $5 trillion. The Cayman Islands (pop. 35,000) has more than $800 billion on deposit—fully one-fifth as much as the entire U.S. banking system.*
>
> *The Internal Revenue Service estimates these deposits are costing the U.S. alone $70 billion a year in uncollected taxes.*
>
> Source: Time Magazine, October 22, 2001

## Federal Excise Tax Regulations

In Announcement 2001-98, the IRS issued final regulations on the requirements for excise tax returns, payments, and deposits, effective for calendar quarters beginning September 30, 2001. This announcement advises taxpayers who file Form 720, "Quarterly Federal Excise Tax Return" of the revised filing and deposit requirements. These changes will be reflected on the 4th quarter Form 720 and its instructions.

### *Filing Dates*

All Forms 720 must be filed by the last day of the month following the quarter for which the return is made. The returns are due by April 30, July 31, October 31, and January 31.

### *Deposit Threshold*

No deposit is required for taxes listed in Part I of Form 720 (including foreign insurance taxes) if the net liability does not exceed $2,500 for the quarter. This is an increase from the previous threshold of $2,000.

### *Deposit Dates*

There are two methods under which deposits can be made: the regular and the alternative method. The classes of tax, referred to as the 9-day rule, 14-day rule, and 30-day rule, have been eliminated. Under the regular method, deposits for a semimonthly period are due by the 14th of the following semimonthly period. Generally, this is the 29th day of the month for the first semimonthly period and the 14th day of the following month for the second semimonthly period. There is no change to deposit dates for taxes deposited under the alternative method.

### *Amount to Deposit and Safe Harbor Rules*

Generally, the deposit of tax for each semimonthly period must be at least 95% of the amount of net tax liability incurred during the semimonthly period. This replaces the requirement to deposit 100% of the net tax liability and the current liability safe harbor rule. The look-back quarter liability safe harbor rule still applies.

## International Insurance Rulings

In 2001 there were significant tax decisions in Canada and the Netherlands regarding insurance companies. In Canada, a Tax Court ruling involving deferred realized gains and taxable capital was upheld. In the Netherlands, the European Court of Justice ruled that Dutch tax authorities may tax insurance premiums paid by a U.K. corporation to a U.K. insurance company with subsidiaries in the Netherlands. Additionally, the United States signed an information exchange agreement with Antigua and Barbuda and issued a Technical Advice Memorandum regarding the trusteed assets of a foreign life insurance company that conducts its U.S. life insurance business through a U.S. branch.

*Rev. Proc. 2000-48: Domestic asset/liability percentages and domestic investment yields needed by foreign insurance companies to compute their minimum effectively connected net investment income.*

*For the first taxable year beginning after December 31, 1999:*

- *114.2 percent for foreign life insurance companies, and*
- *201.6 percent for foreign property and liability insurance companies.*

*For the first taxable year beginning after December 31, 1999, the relevant domestic investment yields are:*

- *8.2 percent for foreign life insurance companies, and*
- *5.6 percent for foreign property and liability insurance companies.*

## Canada

Canadian Federal Court of Appeals upheld a Tax Court ruling that stated that an insurance company was not required to include deferred realized gains on investments in taxable capital.

The Minister of National Revenue (Minister) had assessed the Manufacturer's Life Insurance Company on the basis that the unamortized or deferred portion of gains realized on the disposition of bonds, stock, real estate, and mortgages were included in taxable capital as reserves or surpluses. These amounts were reported as liabilities on the insurer's balance sheet as filed with the Office of the Superintendent of Financial Institutions (OSFI). However, the Tax Court had found that these amounts were not considered to be reserves or surpluses for capital tax purposes and subparagraph 181(3)(b)(ii) of the Canadian Income Tax Act should be read to require that the balance sheet filed with OSFI should be used to determine both the amount and legal character of accounting items for capital tax purposes.

The Minister had argued that subsection 181(3)(b)(ii) required looking to the balance sheet only to determine the amount of an item, not its

character. The Minister relied on *Oerlikon Aeroapatiale Inc. v. Her Majesty the Queen*,[1] in which "an 'advance' was to be reflected in capital because it contributed to "financial resources available to the appellant." The Minister believed that the gains in *Manufacturer's* were financial resources. The Court of Appeal found that the Minister's reliance on *Oerlikon* was misplaced.

***The European Union stepped up pressure on the U.S. to make "wholesale changes" to its tax laws after the World Trade Organization released a report condemning a multibillion-dollar U.S. subsidy scheme for exporters. Although the U.S. amended the program during 2000, to try to meet the EU's objections, the report said that the system, which is worth hundreds of millions of dollars a year to such U.S. companies as Boeing Corp and General Electric Co., is basically unchanged and still breaches WTO rules outlawing export subsidies.***

Source: The Wall Street Journal Europe, August 21, 2001, Geoff Winestock

## Netherlands

In *Kvaerner v. Staatssecretaris*, the European Court of Justice (ECJ) ruled that the Dutch tax authorities may tax insurance premiums paid by a U.K. corporation to a U.K. insurance company to cover its subsidiaries, some within the U.K. and others in the Netherlands.

Kvarener, a U.K. corporation, was the parent company of John Brown plc, another U.K. company, the parent of John Brown Engineers en Constructors BV (John Brown BV), a Netherlands company. Kvarener purchased professional indemnity, worldwide umbrella coverage, and worldwide catastrophe insurance from a U.K. insurer to cover all members of its group. Kvarener paid the premiums on all policies and passed this cost on to its subsidiaries depending upon each entity's risk. Kvarener invoiced John Brown BV, through John Brown plc, for its covered risks.

[1] 99 D.T.C. 5318 (F.C.A.)

Kvarener was assessed tax by the Netherlands tax authorities for the premiums paid by John Brown BV and fought the ruling in Dutch courts. Upon losing the case, Kvarener appealed to a higher Dutch court, which stayed the case and referred it to the ECJ. The larger question then became whether an European Union (EU) member state could "impose an insurance levy on a corporation established in another member state in respect of insurance premiums paid to an insurer also established in the member state for the business insurance of a subsidiary, or sub-subsidiary, established in the member state imposing the levy."

Kvarener argued that since it was a U.K. company that purchased an insurance policy with a U.K. insurer, there should be no Dutch tax levied. Instead, all the policies should be taxed within the U.K. The Dutch authorities contended that since the policies included all global operations, including a portion of the premiums that tied to Dutch insurance risk, it should be taxed by the Netherlands.

The ECJ examined the EU directive that designates that "the establishment of the policyholder." By examining various uses of "establishment," they concluded that although the U.K. parent and its subsidiaries were separate entities, the "establishment" must include all entities underneath the Kvarener umbrella.

Although France, Germany, the Netherlands, and the European Commission supported this ruling, the U.K. dissented. This issue of tax sovereignty will be become more important as the number of countries in the European Union grows.

*Gulzhan Nauryzbekova, a senior official with Kazakhstan's Department of Information Technologies, explained that the television program "Hello Taxpayer" is geared for adult audiences and discusses relevant tax issues in a question-and-answer format. She said another program, "Tax TV," is less technical and aimed at children,. "Tax TV" uses likeable cartoon characters to illustrate the importance of paying taxes as a civic duty.*

Source: Tax Analysts August 1, 2001

# U.S., Barbuda, & Antigua Agree to Exchange Information

The United States and Antigua and Barbuda signed an information exchange agreement on December 6 that permits the exchange of tax information. The agreement will give the United States access to the tax files of Antigua and Barbuda for the purpose of increasing tax shelter compliance. This could have a direct affect on those companies with off-shore tax shelters, in addition to opening the possibility of a similar agreement with other states considered to be tax shelters by the OECD and the IRS.

The contracting states agreed to assist each other to assure the accurate assessment and collection of taxes, to prevent fiscal fraud and evasion, and to develop improved information sources for tax matters. Antigua and Barbuda promised to provide assistance through exchange of information and other related measures to improve tax compliance.

The agreement applies to all federal taxes in the United States. In the case of Antigua and Barbuda, the agreement to share information includes the following taxes: personal and corporate income tax, property tax, business tax, stamp duty, hotel tax, guest tax, telecommunication tax, hotel guest levy, time sharing occupancy tax, time sharing service tax, betting and gaming tax, money transfer levy, restaurant and caterers service tax, offshore banks, casino licenses, banking licenses and fees, and guest levy.

Items specific to the insurance industry include promises to exchange information regarding insurance levies and insurance licenses and fees.

# Annual Statement Not Controlling For Tax Purposes

### TAM 200147007

The "efficacy of the annual statement" argument has been ongoing for years. In yet another instance, the Service voiced its opinion that the annual statement is not necessarily controlling for tax purposes. In TAM 200147007, the IRS ruled that a foreign insurer may not rely on income reported on its NAIC annual statement to determine its effectively connected income.

Taxpayer is a foreign life insurance company that conducts its U.S. life insurance business through a U.S. branch. Taxpayer is required by state law to maintain trusteed assets and deposits in the United States sufficient to satisfy all potential claims of its U.S. policyholders. The trusteed assets held by Taxpayer are required to be included on the NAIC statement, but non-trusteed assets are not reflected in the NAIC statement. Taxpayer did not include income from non-trusteed assets on its U.S. income tax return as effectively connected income and argued that income from these assets is not effectively connected with the conduct of its U.S. insurance business because it is not required to be included on the NAIC statement. The IRS disagreed.

In coming to its conclusion, the IRS assumed that the non-trusteed assets at issue otherwise would constitute assets used in the U.S. life insurance business under the asset-use test of Section 864(c)(2)(A). The IRS rebutted the idea set forth by Taxpayer that Congress intended the NAIC statement to be "determinative of what income is effectively connected to a foreign insurer's U.S. business." Further, the IRS argued that "the legislative history merely states that NAIC statements will USUALLY be followed… It does not support Taxpayer's contention that NAIC statements were intended to be a substitute for the rules in Section 864(c)."

# Chapter 7

## Products

Several Corporate Owned Life Insurance (COLI) cases from previous years are still winding their way through the courts, with Winn-Dixie[1] and Camelot Music[2] still in the appeals stage. Additionally, the cases of Dow Chemical[3] and Ameritech[4] remain to be decided in the North Dakota/Michigan District Court and the Tax Court respectively. However, the courts did finally rule—against the taxpayer—in another anticipated COLI case. *AEP vs. U.S.*[5] was the third in a series of adverse decisions with respect to large case leveraged COLI programs. (Adverse decisions were rendered in 1999 by the Tax Court in the Winn-Dixie case and in 2000 by the District Court (Delaware) in Camelot Holdings.)

The IRS issued a Notice regarding split dollar treatment, hoping to standardize tax treatment of split dollar life insurance policies as interest free loans under Section 7872. The IRS also issued Revenue Procedure 2001-42 to extend Revenue Procedure 99-27. The previous Revenue Procedure had remedied some failures to comply with the MEC rules, but was limited in scope and did not allow sufficient time for implementation. Several Private Letter Rulings (PLRs) regarding motor vehicle protection plans and extended service contracts were also issued. All three PLRs ruled that the contracts were insurance and not prepaid service contracts.

[1] *Winn-Dixie Stores, Inc. v. Commissioner*, T.C., No. 5382-97,113 T.C. No. 21 (October 19, 1999)

[2] In Re CM Holdings, Inc., Camelot Music, Inc.

[3] *The Dow Jones Chemical Co. & Subsids. v. United States*, E.D. Mich.– No. 00-CV-10331-BC

[4] *Ameritech, Inc. v. Commissioner*, Tax Court – No. 12811-00

[5] *American Electric Power v. United States* 136 F. Supp 2d 762 (February 20, 2001)

# COLI

## American Electric Power

The District Court for the Southern District of Ohio ruled that the leveraged COLI program maintained by American Electric Power (AEP) was a sham in substance.[6] Accordingly, the court disallowed claimed deductions for interest paid on policy loans. After reviewing the AEP program in detail, the court concluded that:

- Purported policy loans were shams in fact for the period prior to the date that policies were actually issued (i.e., for the period beginning with the date that revocable prepayments were made and the date the policies were actually issued, fixing the taxpayer's obligation).
- The excessive loading dividends in policy years 4-7, and the corresponding premiums were shams in fact.
- Disregarding these excessive loading premiums, the policy premium structure failed to satisfy the four-out-of-seven rule.
- The COLI program as a whole was lacked economic substance and was a sham in substance.

Additionally, the court expressly rejected the arguments below, namely, that:

- The sham transaction doctrine should not apply because the COLI program at issue was "intended by the statute" (a factual proposition with which the court also disagreed).
- The "economic substance" test should be tested separately with respect to each component member of the consolidated group and not against the consolidated group in the aggregate.
- The existence of a credible non-tax business purpose and a valid use for the program proceeds should satisfy the subjective prong of the economic substance test.

[6] *American Electric Power v. United States* 136 F. Supp 2d 762 (February 20, 2001)

AEP maintained a leveraged COLI program involving COLI VIII policies issued by MBL (the same policies involved in the *Camelot*[7] case). Nevertheless, the company argued that its facts were easily distinguishable from those in *Winn Dixie*[8] and *Camelot*[9] due to both the substance of its business purpose and the quality of the detailed, contemporaneously developed records documenting the underlying non-tax business concerns. AEP argued, and proved to the court's satisfaction, that:

- The policy was adopted to offset or mitigate the impact of FAS 106 by financing the underlying OPEB liabilities,
- Use of the policy was approved by the utility regulators (and indeed was critical to the regulators permitting related costs to be passed through to the taxpayers), and
- AEP established a VEBA to fund its FAS 106 transition liability, to which all earnings realized by the COLI program were contributed.

In this case, the court noted that AEP never considered financing the COLI program with cash and made its decision to purchase the policies based on projections of after-tax cash flow and earnings generated by the maximum amount of policy loans and the highest interest rate it believed would survive IRS scrutiny. In addition, AEP's program, like the COLI programs reviewed in Winn Dixie[10] and Camelot,[11] would have produced negative cash flows absent the tax savings attributable to policy loan interest deductions. Accordingly, the court concluded that a subjective analysis indicated that AEP's purpose was tax-motivated. The case has not yet been appealed.

[7] *In Re CM Holdings, Inc., Camelot Music, Inc., v. IRS* 254 B.R. 578 (October 16, 2000)

[8] T.C., No. 5382-97, 113 T.C. No. 21 (October 19, 1999)

[9] *In Re CM Holdings, Inc., Camelot Music, Inc., v. IRS* 254 B.R. 578 (October 16, 2000)

[10] T.C., No. 5382-97, 113 T.C. No. 21 (October 19, 1999)

[11] *In Re CM Holdings, Inc., Camelot Music, Inc., v. IRS* 254 B.R. 578 (October 16, 2000)

*Speaking at a PricewaterhouseCoopers insurance conference in New York, insurance executives said that Internet sales were lower than expected. Customers continue to choose an agent over buying insurance via the Internet or through a call center. Small commercial insurers and individuals use the Internet primarily as an information source, but have no desire to buy insurance online.*

Source: Dow Jones New Service, Chad Bray, November 28, 2001

## Winn-Dixie

The 11th Circuit Appeals Court affirmed the Tax Court ruling that Winn-Dixie[12] was not entitled to deduct interest and fees incurred in borrowing against insurance policies that it owned on the lives of its employees. The Appeals Court concluded that there was no business need for the program, and the COLI program lacked economic substance to be respected for tax purposes.

The Tax Court had ruled that a leveraged COLI program was a sham transaction in *Winn-Dixie Stores, Inc. v. Commissioner*.[13] Thus, Winn-Dixie was not entitled to deduct the interest on either the policy loans or the program's administrative fees.

In 1993, Winn-Dixie purchased COLI on the lives of its 36,000 full time employees. Winn- Dixie was both the policy owner and beneficiary. The payment decision made for the plan was considered a "zero-cash strategy." This strategy involved borrowing against cash surrender value for the first three premiums and withdrawing accumulated policy values to pay for the next four premiums.

In determining the transaction was a sham, the Tax Court looked at two factors: economic substance apart from tax consequences and business purpose. The court determined that since the COLI program lacked both "economic substance and business purpose (other than tax reduction),"

[12] *Winn-Dixie Stores, Inc. v. Commissioner*, 254 F.3d 1313 (June 28, 2001)

[13] T.C., No. 5382-97, 113 T.C. No. 21 (Oct. 19, 1999)

it was a sham transaction entered into for tax purposes. Therefore, the court ruled that the interest on the policy loans and the accompanying administrative fees were not deductible.

Winn-Dixie made several arguments on appeal. First, the company argued that since the Internal Revenue Code explicitly authorizes the deduction of interest and fees incurred in specific types of borrowing against whole life insurance policies, the application of the sham transaction doctrine is inappropriate. Winn-Dixie also argued that if the sham transaction did apply, the Tax Court did not take into account the economic substance and business purpose aspects of the transaction.

The Appeals Court noted that the Supreme Court had ruled on a similar argument to Winn-Dixie's first point in *Knetsch v. United States*.[14] The Supreme Court concluded the fact that Congress did not close a tax loophole **was not** the same as their blessing it and to attribute such an intention would "exalt artifice above reality."

Finally, the Appeals Court noted that a transaction is not respected for tax if it lacks economic effects or substance other than the generation of tax benefits. The Tax Court followed a ruling in *Kirchman v. Commissioner*,[15] that stated, "[I]t is clear that transactions whose sole function is to produce tax deductions are substantive shams." The Appeals Court determined that the Winn-Dixie program had no economic substance since it would never make a profit, demonstrated by the fact that the company pulled out after changes to tax law. Based on the lack of business purpose and economic substance, the Tax Court ruling was affirmed.

It is interesting to note that in comparing the recent UPS decision to that reached in *Winn-Dixie*, the 11th Circuit decided two high profile "sham" transaction cases differently. Based on case discussions, it appears reasonable to conclude that as long as there is a bona-fide business purpose to

[14] 81 S. Ct. 132

[15] 862 F.2d 1486

a transaction, tax implications may be considered in that transaction's planning. However, tax considerations should not be the only reason for a specific transaction to take place.

Winn-Dixie is currently seeking a rehearing in the 11th Circuit Court.

## Camelot Music Appeal

In October 2000, the District Court ruled in *IRS v. CM Holdings, Inc.,*[16] that the COLI policies developed by the company were shams in both fact and substance and disallowed the interest deductions relating to the policies. Additionally, the Sec. 6662 accuracy related penalties assessed by the IRS for understatement of income tax were upheld. The court rejected Camelot's claims that the plan was purchased to recover and provide employee medical benefits and that the company had a reasonable expectation of profit over the life of the transaction, even without the tax benefit. Likewise the court ruled that the COLI program did not meet the "four-of-seven" rule. And that since the premiums paid in years 4-7 were considered shams, there was no level premium for the first seven years of the program.

The case has been appealed by Camelot Music. In their brief for the Third Circuit,[17] the company argues that its COLI program had economic substance and thus was not a sham for tax purposes. The corporation notes that a transaction is not a sham because it lacks pre-tax profitability and that even if a subjective analysis is required under the sham doctrine, Camelot's policies had subjective economic substance. Further, CM Holdings argues that it did not violate the "four-of-seven" rule under Section 264.

The case is waiting a hearing.

[16] *In re CM Holdings, Inc., Camelot Music, Inc. v. IRS* 254 B.R. 578 (October 16, 2000)

[17] *CM Holdings, Inc. et al. v. IRS*; No. 00-3875 (30 July 2001)

*Seventy-six million baby boomers will begin retiring in about 2010, and in about 30 years, there will be nearly twice as many older Americans as there are today.*

*At the same time, the number of workers paying into Social Security per beneficiary will drop from 3.4 to 2.1. These changes will strain our retirement system. Benefit payments will begin to exceed taxes paid in 2015, and by 2037, Social Security will be able to pay only about 72% of benefits owed.*

Source: www.ssa.gov/pubs

## Notice 2001 - 10: Split Dollar Interim Guidance

IRS Notice 2001-10 requires a significant change in the taxation of split dollar life insurance policies. Although the Notice mainly covers employer/employee split-dollar life contracts, it also applies to transactions compensating non-employees, corporate shareholders or those used in the gift context.

The Notice prospectively permits employers to characterize equity split dollar arrangements as interest free loans subject to Section 7872. The employer premium payments would be taxed under Section 7872 and the employee will not be taxed on the current value of life insurance protection. It also deems all split-dollar programs that have not, since inception, consistently treated the employer premium payments as interest-free loans under section 7872 to have adopted a "non-loan" characterization of the arrangement.

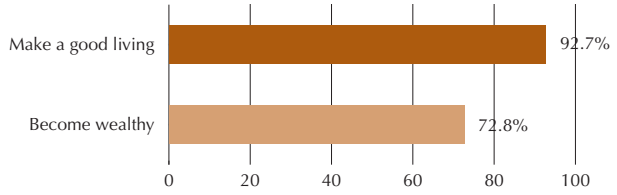
The Notice stipulates that:

- The employer will be treated as having acquired a beneficial interest in the policy through its share of premium payments (unless no reimbursement is intended).

- The covered employee will have **(i)** Section 61 compensation income equal to the value of current life insurance protection (reduced, as under prior law, by any payments made by the employee); **(ii)** Section 61 income equal to the value of any dividends distributed or applied to purchase additional coverage; and **(iii)** compensation income under Section 83(a) to the extent that the employee acquires a substantially vested interest in the cash surrender value (reduced by the value of consideration, if any, paid by the employee).

Notice 2001-10 also provides that no employer will be treated as having made a transfer of the cash surrender value within the meaning of Section 83 solely because interest or other earnings cause the cash surrender value to exceed the amount reimbursable to the employer. Since in most equity split-dollar arrangements, the employer does reserve the right to recoup premiums, and since the cash surrender value only increases, this seems to suggest that the Notice merely establishes principles for taxing equity split dollar policies. These principles in most instances will not have current impact unless further guidance clarifies that earnings will be considered to create a Section 83 transfer.

**BECOMING WEALTHY AS A MOTIVATION TO PROVIDE LIFE INSURANCE**




N= 322 MORT producers

Source: National Underwriter, July 30, 2001

The Notice also provides that any employer premiums or other payments made to a split-dollar program in which the employer neither acquires a beneficial interest nor has a reasonable expectation of reimbursement will be taxed to the covered employee as current compensation. The

standards for measuring the value of current life insurance protection will also change. The outdated PS 58 tables will be replaced with newly issued Table 2001. Taxpayers may continue to use PS 58 for taxable years ending on or before December 31, 2001.

For years beginning after December 31, 2003, the insurer's lower published premium rates for initial year standard risks will be changed by limiting premiums eligible to be used for this measurement to those specified in the Announcement.

*Early in 2002, the IRS released Notice 2002-8, revoking Notice 2001-10. The new Notice announces that the IRS intends to publish proposed regulations for the tax treatment of split-dollar life insurance arrangements.*

## MEC Correction Extended

The IRS has released Revenue Procedure 2001-42 which extends the procedures previously put forward in Revenue Procedure 99-27 for obtaining a closing agreement to correct the "inadvertent non-egregious" failure to comply with the modified endowment contract (MEC) rules of Section 7702A. Revenue Procedure 99-27 was limited in that it generally only allowed for one correction request and excluded certain contracts. Additionally, the May 31, 2001 deadline was insufficient for all issuers to file timely requests.

The new Revenue Procedure lists the procedures for obtaining a closing agreement relating to life insurance contracts that fail to satisfy the "7-pay" test set forth in Section 7702A(b). A consequence of MEC status is that distributions are taxed on an "income out first basis" pursuant to Section 72(e)(11) rather than the usual "basis out first" rules under Section 72(e)(5).

To receive a closing agreement under Revenue Procedure 2001-42, an issuer must submit a ruling request that complies with the requirements of Revenue Procedure 2001-1, as well as a proposed closing agreement.

Revenue Procedure 2001-42, sets forth the specific information that must be included in the submission.

The issuer must also submit a proposed closing agreement that conforms to the model agreement provided in the Revenue Procedure. The proposed closing agreement must include the amounts to be paid for all of the contracts covered by the agreement. There is a special *de minimis* rule for contracts whose earnings do not exceed $75 during the testing period.

The issuer is required to pay the amount determined under the Revenue Procedure within 30 days of the date of execution of the closing agreement. The issuer must also bring each contract into compliance with Section 7702A.

> ***The American Council of Life Insurers in Washington, D.C., wrote March 12 to express "serious concerns" regarding Notice 2001-10. ACLI noted that the notice, coupled with its application to long-standing existing arrangements, "has created substantial confusion and concern among employees, employers and issuers of life insurance contracts under split-dollar arrangements."***
>
> Source: BNA Daily Tax Report July 13, 2001

## Motor Vehicle Protection Plans

The IRS issued Private Letter Rulings on two motor vehicle protection plans. The first ruling, LTR 20019039, was a standard ruling on extended warranty insurance contracts where the company issued protective plans through third party dealers. The second ruling differs significantly from prior extended warranty rulings, in that a potential servicer on the extended warranty contracts is the parent company of the obligor/insurance company. This is an important deviation from the fact patterns presented in past IRS rulings which distinguish between a "prepaid service contract" and an "insurance contract" and seems to conclude that a related party servicer, as long as it is not the insurance company, is accept-

able. Factors important in determining both rulings included third-party indemnification, significant acceptance of risk, and lack of repair services provided by taxpayer.

### LTR 200119039

The IRS determined in LTR 200119039 that a motor vehicle protection company was considered an insurance company for federal income tax purposes. The company issued four types of protective plans through third party automobile dealers. Contracts 2), 3), and 4) were considered to be insurance contracts and the company an "insurance company" since the "primary and predominant" business activity of the taxpayer was the issuing of such contracts.

The taxpayer's customers purchased motor vehicle protection plans from the taxpayer through their auto dealer when the vehicle purchase was made. The plans covered the customers in case of vehicle mechanical break down. Four types of contracts were available through the plan, including 1) dealer obligor contracts that were reinsured with a third party commercial insurance company, 2) dealer obligor contracts in which the taxpayer assumed and retained the insurance risks, 3) taxpayer obligor contracts on which the taxpayer retained all of the risks and, 4) taxpayer obligor contracts in which the taxpayer reinsured to a third-party insurance company. Over 75% of the risks were retained by the taxpayer and not reinsured.

### LTR 200138010

In LTR 200138010, the IRS determined the motor vehicle protection plans provided by a company were considered to be insurance contracts and that the company is an "insurance company."

The company that issued the motor vehicle protection plans (Company) was owned by an automobile dealership (Dealer) and was the obligor in the issuance of motor vehicle service contracts (MVSCs), marketed by Dealer. The MVSCs covered expenses beyond the dealer warranty. They did not cover routine maintenance on the vehicles. The contracts were sold by Dealer, who also collected the premiums from the customer.

Dealer remitted a portion of each premium to Company, and retained the balance as a "commission." Company entered into a reinsurance agreement with a third party insurance company for any risk over $400 per contract during a 12-month period.

## Extended Service Contracts are Insurance

**PLR 200140057**

In a Private Letter Ruling closely related to the motor vehicle protection plan rulings issued earlier in the year, the IRS concluded that certain extended service contracts are insurance contracts for federal tax purposes and that the Taxpayer is an insurance company under Section 831 of the Internal Revenue Code. Important factors in the decision that contracts are not prepaid service contracts are that no more than five percent of the premiums will be attributable to preventative maintenance; Taxpayer will not provide any repair services itself; Taxpayer is obligated to indemnify contract holder; and Taxpayer will not reimburse obligations that are the obligations of dealers or independent insurance companies.

The Taxpayer will issue and administer "Extended Service Contracts" (ESCs) to the purchasers of certain durable goods. The ESCs will provide the purchaser with protection against economic loss resulting from the good's breakdown, so long as the loss is not covered by the manufacturer's warranty for the good. The Taxpayer's entire business will consist of the issuance and administration of ESCs in three forms: **1)** Taxpayer Obligor Contracts, **2)** Dealer Obligor Contracts, **3)** Insurance Company Obligor Contracts. The Taxpayer will provide only administrative services for the Insurance Company Obligor Contracts and the Dealer Obligor Contracts, while Taxpayer's predominate source of revenue will be derived from the issuance of Taxpayer Obligor Contracts. The Taxpayer will be liable for specific costs of repair to covered goods and will remain directly liable to the purchasers of the Taxpayer Obligor Contacts. The Taxpayer will purchase coverage from third party insurers to cover some risks, in order to comply with certain state requirements. The Taxpayer will not perform any repairs.

# Chapter 8
## Other

In 2000 the IRS lost two major cases when United Dominion[1] and U.S. Freightways[2] decisions overturned Appeals and Tax Court rulings and remanded them to their respective courts. The United Dominion[3] case, which went all the way to the Supreme Court, overturned a Fourth Circuit Court decision and found that 10-year NOL carrybacks for product liability losses must be calculated on a consolidated basis. However, in *Nichols v. United States*,[4] the Sixth Circuit Court of Appeals ruled in favor of the IRS when it concluded that the Secretary did not exceed its authority under Sections 1502 and 1503 in creating anti-carryback legislation relating to life/non-life consolidated returns.

Other decisions in tax and circuit courts in 2001 largely followed IRS views. In a Tax Court decision, the IRS won an unsurprising victory over research credits related to insurance software. Additionally, the IRS released new proposed R&D regulations which are expected to clarify the previous regulations. The new regulations eliminate the specific "discovery test" and may make the R&D credit even less viable for innovative software projects. In *Lychuk v. Commissioner*,[5] the Tax Court ruled in favor of the IRS on the issue of capitalization of salaries and benefits related to installment contracts.

[1] *United Dominion Industries v. Commissioner*, 121 s. Ct. 1934 (June 4, 2001)

[2] *U.S. Freightways Corp., f.k.a. TNT Freightways Corp., and Subsidiaries v. Commissioner* 270 F. 3d 1137 (November 6, 2001)

[3] *United Dominion Industries v. Commissioner*, 121 s. Ct. 1934 (June 4, 2001)

[4] *George Nichols III, in his capacity as litigator of Kentucky Central Life Insurance Company v. Commissioner*, 260 F. 3d 637 (August 13, 2001)

[5] *Lychuk v. Commissioner*, 116 T.C. 374 (May 31, 2000)

The IRS issued a diverse assortment of rulings during 2001. One of the first rulings of the year was a Revenue Procedure providing guidance concerning automatic consent for changes in accounting method for cash advances on commissions paid to insurance agents. Final regulations under Section 6302, updated mortality and morbidity tables, and the applicability of "look-through" rules were also among IRS rulings during 2001, as was a Field Service Advice concluding that each Blue Cross/Blue Shield member of a consolidated group should separately calculate the income limitation on the Section 833 deduction.

# United Dominion - Treatment of 10-year Consolidated NOLs

In an 8-1 decision, the Supreme Court reversed and remanded the Fourth Circuit in *United Dominion Industries v. Commissioner*,[6] holding that an affiliated group's product liability losses (PLL) must be figured on a consolidated "single-entity" basis, and not by segregating PLLs on a company-by-company basis. The Supreme Court's opinion focuses almost entirely on a threshold definitional question "Is there any 10-year NOL to carry back?" to which the answer was "Yes." The Court did not address how much of that loss is properly carried back to prior years of the group and how much is carried back to prior years of the various members before they joined the group; however, the consolidated return rules have a general answer to this question. Since consolidated NOLs generally are allocated among all the members having separate company losses, it seems reasonable to apply the same apportionment rules to 10-year carrybacks.

In 1978, Congress authorized a special 10-year carryback for "product liability losses," now termed, "special liability losses." The Code defined "product liability loss," for a given tax year, as the lesser of **1)** the taxpayer's NOL for such year and **2)** its allowable deductions attributable to product liability expenses.

The narrow question presented in *United Dominion* was how members of a consolidated group should compute a 10-year carryback. Under a "separate-member" approach, no 10-year NOL carryback would be allowed unless the member incurring the qualifying expenses also demonstrated a separate company NOL. The "single-entity" approach would permit a 10-year carryback as long as the group as a whole generated a consolidated NOL and some members incurred qualifying expenses. The Supreme Court followed the "single-entity" approach.

United Dominion's predecessor, AMCA, was the parent of an affiliated group of corporations that properly elected to file consolidated tax returns for the years 1983 through 1986. In each of these years, AMCA reported

[6] *United Dominion Industries v. Commissioner*, 121 S.Ct. 1934 (June 4, 2001)

a consolidated NOL that exceeded the group's specified liability losses. The case focuses on the specified liability losses of five of the group's members, each of which reported positive separate company income.

AMCA calculated its consolidated NOL by aggregating its individual members' qualifying specified liability expenses, essentially following a single-entity approach. For each tax year that AMCA's consolidated NOL was greater than the sum of its members' specified liability expenses, AMCA treated the full amount of the specified liability expenses as a consolidated 10-year NOL carryback. In 1986 and 1987, AMCA petitioned the Internal Revenue Service for refunds. The IRS first ruled in AMCA's favor but was reversed by the Joint Committee, which controls refunds exceeding $1 million dollars. AMCA then filed the refund action that ultimately culminated in this opinion.

The District Court agreed with AMCA but the Fourth Circuit reversed, holding that determining 10-year NOLs separately for each group member is consistent with the regulations. Because the Fourth Circuit's "separate-member" approach conflicted with the Sixth Circuit's adoption of the "single-entity" approach in *Intermet Corp. v. Commissioner*, 209 F.3d 901 (6th Cir. 2000), the Supreme Court granted certiorari.

**NOTICE 2001-24: TENTATIVE DETERMINATION OF RATES TO BE USED FOR TAXABLE YEARS BEGINNING IN 2000**

| | |
|---|---|
| Differential earnings rate for 2000 | 0 |
| Recomputed differential earnings rate for 1999 | 0 |
| Imputed earnings rate for 1999 | 15.815 |
| Imputed earnings rate for 2000 | 15.358 |
| Base period stock earnings rate | 18.221 |
| Current stock earnings rate for 2000 | 16.960 |
| Stock earnings rate for 1997 | 19.321 |
| Stock earnings rate for 1998 | 15.836 |
| Stock earnings rate for 1999 | 15.724 |
| Average mutual earnings rate for 1998 | 16.011 |
| Average mutual earnings rate for 1999 | 16.164 |

# U.S. Freightways Reversed and Remanded

In *U.S. Freightways Corp., f.k.a. TNT Frieghtways Corp., and Subsidiaries v. Commissioner*,[7] the Seventh Circuit Court of Appeals reversed and remanded the case to the Tax Court.

Freightways, a long-haul freight trucking company, purchases a large number of permits and licenses and pays significant insurance premiums in order to legally operate its vehicles. The benefits of the fees and insurance premiums paid did not extend beyond a year from the time the expense was incurred; however, because the expenses were incurred at different times during the tax year, Freightways enjoyed in 1994 substantial benefits of the expenses it incurred in 1993. Despite the subsequent tax year benefits, Freightways, which otherwise uses accrual accounting, deducted the entire amount of expenses in its 1993 tax return. Under audit, the Commissioner concluded that Freightways should have capitalized its 1993 expenses and deducted them ratably over the 1993 and 1994 tax years. Freightways appealed.

The central argument of the Tax Court was "that no matter what other characteristics an expenditure has, if it is made in one tax year and its useful life extends substantially beyond the close of that year, then it must be capitalized." Given the lack of resolution in the Regulations and in the Courts, and the wide variety of circumstances regarding the definition of "substantially," the Circuit Court pointed to the regularity of the expenses incurred and found that Freightways' expenses should be deducted based on the fact that both the Circuit Court and the IRS have recognized this type of regularity as "something that tends to support a finding of deductibility."

In coming to its decision, the Circuit Court agreed with the Tax Court that there is no rule under which all prepaid expenses with a useful life of only one year are entitled to treatment as deductible ordinary expenses, but rejected its position that even if there were some kind of one-year

[7] *U.S. Freightways Corp., f.k.a. TNT Frieghtways Corp., and Subsidiaries v. Commissioner* 270 F.3d 1137 (November 6, 2001)

rule, accrual taxpayers are never entitled to it. In addition, the Court found that the change in the company's tax accounting suggested by the Commissioner would impose an administrative burden.

With regards to the insurance expenses at issue in this case, the Circuit Court ruled that "the balance of the factors under the statute and regulations cut in favor of treating them as deductible expenses under Section 162(a)." The conclusion hinged on the fact that the expenses were "fixed, one-year items where the benefit will never extend beyond that term, that are ordinary, necessary, and recurring expenses for the business in question." The question of whether Freightways' method of accounting clearly reflected its income was remanded to the Tax Court.

*According to the Independent Insurance Agents of America's "Agency Universe Study 2000," the use of the Internet is growing. Since the IIAA's last report in 1996, agents' access to the Internet has grown from 8 Percent to 93 percent, the Alexandria, Virginia association reported.*

*The embrace of the Web is not total, however. According to the report, while 97 percent of agencies say they use the Internet for e-mail, only 36 percent say they have Websites. Meanwhile, only 27 percent said they receive and send claims over the Internet, and a mere 8 percent use the Internet to send documents to clients.*

Source: National Underwriter: Property & Casualty/Risk & Benefits Management Edition, August 13, 2001

## Life/Non-Life Anti-Carryback Regulations Ruled Valid

In *Nichols v. United States*,[8] the United States Court of Appeals for the Sixth Circuit ruled that the Secretary did not exceed its authority under IRC Sections 1502 and 1503 in creating anti-carryback legislation relating to life/non-life consolidated returns.

[8] *George Nichols III, in his capacity as Liquidator of Kentucky Central Life Insurance Company v. United States* 260 F. 3d 637 (August 13, 2001)

Kentucky Central Life Insurance Co. (KCL) was the life insurance parent of several non-insurance subsidiaries. KCL and its subsidiaries filed a life-nonlife consolidated tax return. In 1997, KCL filed suit in the United States District Court for the Eastern District of Kentucky seeking a refund of federal income tax paid by KCL, claiming that Treasury Regulations 1.1502-47(a)(2)(ii) and 1.1502-47(l)(3) were invalid since they prevented KCL from offsetting life insurance losses against nonlife insurance income.

The government denied the request for a refund. On July 17, 1998, the District Court disagreed with KCL's position and granted the government's motion for summary judgement. Nichols filed a timely appeal on April 27, 1999. Under appeal, KCL challenged the ban on life carrybacks against nonlife income, arguing that when Congress allowed the ban on life-nonlife consolidated returns, they did not intend to restrict the carry-back of life losses against nonlife income. By creating regulations that banned life-nonlife groups from carrying back life losses against nonlife income, KCL claimed that the Secretary had "impermissibly intruded upon the language, structure, purposes and legislative history of Section 1507 of the Tax Reform Act of 1976."

The United States Court of Appeals affirmed the District Court's granting of summary judgment to the government. The appeals court stated that the district court had properly concluded that the anti-carryback regulation is "not arbitrary, capricious, or manifestly contrary" to the Tax Reform Act. The Court of Appeals believed that the regulation was a proper exercise of power by the Secretary. The Plaintiff was unable to demonstrate any language that expressly allowed the carryback of life losses against nonlife income. Also, the court concluded that the regulation was reasonable interpretation and was supported by case law.

In the past few years, several cases have been decided in which the Courts ruled that Treasury had not overstepped its bounds or gone beyond Congressional intent. Some cases of note include *Atlantic Mutual Insurance Co v. Commissioner,*[9] *Bankers Life and Casualty Co. v. U.S.*,[10] and *CUNA Mutual v. Commissioner*.[11]

[9] *Atlantic Mutual Insurance Co. v. Commissioner*, 118 S. Ct. 1413 (1998)

[10] *Bankers Life and Casualty Co. v. U.S.*, 142 F. 3d 973 (7th Cir. 1998)

[11] *CUNA Mutual v. Commissioner*, 1997-2 USTC 50, 904 (Ct. Fed. Cl. 1997)

# Research Credit Relating to Insurance Software Disallowed

The Tax Court, in agreement with the IRS, concluded that an S corporation, Applied Systems Inc. (ASI) was not eligible for the Section 41 research credit relating to insurance software.[12] The court indicated that "Petitioners fell woefully short of presenting sufficient evidence to establish, as required by Section 41, that Applied Systems did not undertake research to discover information beyond the state of knowledge in the computer science field."

ASI produced insurance agency computer software. The software was used to process client and insurance policy information, invoices, insurance claims, standard insurance forms, and premium calculations. ASI made approximately 190 modifications to the insurance software over the years in question to update the initially released version. ASI also had several other ongoing projects related to new product offerings. ASI did not take the research credit for the tax years 1990-1992.

However, a new tax manager attempted to utilize the credits through the use of amended returns.

The IRS disallowed the R&D credit amounts stating that ASI's product improvements did not meet the "qualified research" and "process of experimentation" requirements of Section 41. The company disagreed, stating that they had made "significant programming changes to software," rather than mere upgrades.

The Tax Court ruled that the "research" undertaken by ASI was already developed in the industry and it did not advance knowledge in the area. Furthermore, the "petitioner's reconstruction of qualifying expenses was unreliable, inaccurate, incomplete, and wholly insufficient to establish what various workers did and whether such expenses qualify for the research credit." The court concluded that the partners in the S corporation would not be entitled to R&D credits for the applicable tax years.

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

This case again demonstrates the need for good written documentation to support the use of the Section 41 research credit. Moreover, companies should keep in mind the higher standards of "experimentation" in order to claim the credit.

*The IRS released new proposed R&D regulations late this year. The new proposed regulations eliminate the discovery test; however, with respect to internal use software, the proposed regulations appear to be unfavorable for insurance companies. While the overall discovery test was eliminated, it was added to the internal use software requirements. The proposed regulation indicate that to satisfy the innovativeness test, the software must be intended to "be unique or novel and is intended to differ in a significant and inventive way from prior software implementations or methods." Examples in the regulations also indicate that the determination of "significant" or "inventive" will be made in comparison with the software of others, including industry participants and competitors.*

## Lychuk: Direct Loan Acquisition Costs should be Capitalized

The Tax Court ruled in *Lychuk v. Commissioner*,[13] that a taxpayer who acquired and serviced multi-year installment contracts in the ordinary course of business must capitalize salaries and benefits directly related to their acquisition. The taxpayer could deduct under Section 165(a) expenditures attributed to installment contracts that it did not acquire.

The taxpayer, through his automobile credit corporation, purchased installment contracts sold by automobile dealers to their customers. Lychuk chose which individual contracts to purchase and incurred various expenses in deciding whether or not to accept a contract. These expenses included items related to reviewing the credit application, such as salaries, benefits and overhead.

[13] *Lychuk v. Commissioner*, 116 T.C. 374 (May 31, 2000)

The Tax Court determined that Lychuk was required to capitalize the salaries and benefits related to its acquisition of the installment contracts since these costs were directly related to the installment contract purchase. However the overhead costs were not found to be directly related to the acquisition of the installment contracts and thus could be deducted.

It should be noted that in a dissenting opinion, seven justices contended that the overhead costs were directly related to the acquisition and should have been capitalized. The confusion regarding this issue is obvious; in fact, one of the judges stated that "the time has come to request respectfully that the Congress step in and enact some bright-line rules that will provide guidance to the business community and the Internal Revenue Service and reduce the burdens of compliance and controversy on the public, the Service, and the courts."

## Cash Advances to Insurance Agents

The IRS released Revenue Procedure 2001-24, which provides procedures by which an insurance company may obtain automatic consent to change its method of accounting for certain cash advances on commissions paid to its agents from deducting a cash advance in the taxable year **paid** to the agent to deducting a cash advance in the taxable year **earned** by the agent. Revenue Procedure 2001-24 is effective for taxable years beginning after 1999. These procedures apply only to payments considered to be loans under this Revenue Procedure and to cash advances paid by the Company to an agent under conditions stated in the Procedure.

To use this treatment for the first or second year beginning after December 31, 1999, companies must file an automatic change in accounting method. If the accounting method is changed, the cash advance should be treated as compensation by the agent in the year earned rather than paid. Accordingly, the employee will subject the earned cash advance to all appropriate withholding taxes.

This revenue procedure contradicts the recent TAM 200040004 relating to brokers, which stated that payments made in conjunction with a bonus

agreement and promissory note were considered compensation to the broker when paid by the employer, but were only deductible by the employer when earned by the broker. It should be noted that the IRS saw no indication of a loan in the facts of the TAM.

*A total disability claim can be costly for a baseball insurer. When a degenerative left hip injury forced Albert Belle into retirement before the start of the 2001 season, the Baltimore Orioles filed a $27 million claim to cover the final two years of the guaranteed $46.5 million contract the former all-star had signed three years earlier.*

Source: National underwriter P&C October 15, 2001

## Capital Asset Receipts Should be Traced

The IRS concluded in FSA 200120004 that an insurance company needed to chronologically trace its gross receipts from capital assets sales rather than choosing specific transactions when calculating the abnormal capital loss deduction amount under Section 832(c)(5).

The taxpayer was a stock property and casualty insurance company that filed a consolidated tax return. In Year X, the taxpayer claimed a deduction under Section 832(c)(5) for capital losses to fund abnormal insurance losses. This deduction was calculated by comparing cash expenditures relating to policyholder dividends, losses, and expenses to cash receipts resulting from capital asset sales. Since the taxpayer had made many capital asset sales during the year, gross receipts exceeded the amount allowed for Section 832(c)(5) losses. The specific items chosen gave the taxpayer the greatest possible deductible loss.

The examining agent suggested that the deduction be calculated by chronologically tracing capital asset sales, stopping when the sales have met the maximum limitation under Section 832(c)(5). Under Section 832(c)(5), an insurance company is allowed a capital loss deduction in excess of capital gains to the extent capital assets are sold or exchanged in order to meet abnormal insurance losses and provide for certain other

policyholder distributions. Quantitatively, the gross receipts from capital assets sold to obtain such funds cannot be greater than 1) the sum of the insurance company's cash expenditures with respect to policyholder dividends, losses, and expenses, over 2) the sum of the insurance company's gross receipts with respect to investment income (excluding capital gains) and net premiums received. Apportionment should be used if gross receipts are greater than the excess amount allowed.

Once the gross receipts relating to the specific capital assets exceed cash disbursements, later sales of capital assets are not eligible for Section 832(b)(5) treatment. The IRS concluded that the determination of the sales for purposes of Section 832(b)(5) should be based upon "the quantitative test set forth in the statute" rather than subjective choices by the insurance company. The IRS also noted that choosing assets chronologically would be consistent with legislative intent to provide relief to an insurance company and would prevent the administrative problem of record keeping regarding the purpose specific capital sales.

*Federal Reserve Banks Removed as Federal Depositories*

*The IRS issued final regulations under Section 6302 that permanently remove Federal Reserve banks as authorized depositories for federal tax deposits. The final regulations which adopt the proposed regulations published December 26, 2000, remove the related temporary regulations and are effective for deposits made after December 31, 2000.*

*Under the final regulations, taxpayers may no longer make federal tax deposits using paper federal tax deposit coupons (Form 1089) at Federal Reserve Banks. The regulations do not prohibit federal tax deposits in federal and state chartered banks recognized as part of the Federal Reserve System. Therefore, Federal Tax Deposits made with paper coupons relating to financial institutions that serve as Treasury Tax and Loan (TT&L) depositories are not affected. Additionally, deposits made through the Electronic Federal Tax Payment System (EFTPS) are not affected.*

*The final regulations apply to deposits made after December 31, 2000.*

## Temporary and Proposed Tax Shelter Regulations

On February 28, 2000, the IRS released temporary and proposed regulations under Sections 6011, 6111, and 6112. The new regulations impose new corporate tax shelter reporting requirements. The proposed and temporary regulations require certain corporate taxpayers to file tax shelter disclosure statements with their federal corporate income tax returns. They also require promoters and advisors to register confidential corporate tax shelters and to maintain lists of investors in potentially abusive tax shelters. The regulations are part of an ongoing effort to address what the Federal Government perceives to be a proliferation of corporate tax shelters.

*In the non-Internet world, the combined cost to insurers and physicians of processing a single transaction is between $8.50 and $18, according to a study by PricewaterhouseCoopers L.L.P. and Milliman & Robertson Inc.*

*The savings possible from using Internet processing could be billions of dollars a year, if the experience of Partners National Health Plans of North Carolina Inc. is any guide. Partners said in December that it was saving about $1.43 on every transaction it moved to the Web. The industry handles nearly 5 billion clams annually, according to RealMed Corp., an Indianapolis company that develops Internet portals for insurance companies.*

Source: Philadelphia Inquirer February 26, 2001

## IRS Denies Correction of Error in Closed Tax Year

**FSA 200143003**

In FSA 200143003, the IRS ruled that it may not correct an error in a closed tax year unless the Taxpayer's position is sustained in a determination for an open tax year.

In Year 1, Taxpayer sold its stock to X, and in Year 2, Taxpayer merged with X. For Year 2, Taxpayer filed two short period returns, one for the period before the merger, and one for the period following the merger. During Year 2 Taxpayer overstated its life insurance reserves. The overstatement was allocated ratably to the first and second short period tax returns. In preparing its return for Year 3, X realized that its Year 2 reserves were overstated. Instead of amending the Year 2 returns or including the amount of overstatement in income in Year 3, X restated the amount of life insurance reserves at the beginning of Year 3 to avoid any adjustment to gross income.

X would like to correct the overstatement of reserves by filing an amended return for its short tax year and having Taxpayer amend its return for the short tax year which ended the day before the merger date. The period of limitations for making an assessment remains open for X's short year return, but is closed for Taxpayer's short year return.

In making its decision, the IRS examined the mitigation provisions of Sections 1311 through 1314. Of the four conditions that must be met to adjust an error in a closed tax year, Taxpayer's situation meets only the first. The IRS concluded, "If X's position for its Year 3 tax year is sustained in a determination, it will secure a benefit. But the error in [Taxpayer's] short tax year ending on the day before the merger is not one for which an adjustment is authorized under the mitigation provisions."

## Forms 1099 For Independent Agents

### FSA 200148022

In Field Service Advice 200148022, the IRS narrowly construed Rev. Rul. 57-747 and the statutory rule of construction in requiring the Taxpayer to issue Forms 1099 for commissions paid to independent agents.

Taxpayer is a title insurance company. Independent agents sell Taxpayer's policies throughout the United States. Premiums on title insurance policies are collected by the agents, who retain a portion of the premium as

fees before remitting the remainder to Taxpayer. Taxpayer records the entire amount of the premium as income and simultaneously records the associated fee retained by the agent as an expense. Taxpayer does not issue Forms 1099 for commissions retained by its independent agents.

Treas. Reg. 1.6041-3(h) grants an exception to the information return requirement for payments of commissions to general agents by companies insuring property. For Taxpayer to qualify for the exception, Taxpayer's agents must qualify as "general agents" and Taxpayer must qualify as a "company insuring property."

Using the definition in Revenue Ruling 57-747, the IRS determined Taxpayer's agents to be general agents because they are granted the authority to receive and process applications for insurance, perform title searches, collect premiums, and issue title insurance policies binding Taxpayer.

The term "companies insuring property" is not defined in the Code or the Regulations. Using "fire insurance companies" and "casualty insurance companies" as a guide, the IRS concluded that because title insurance does not insure against the physical loss of property, "title insurance would not be included in the term 'companies insuring property.'"

Because Taxpayer does not meet the requirements of Treas. Reg. 1.6041-3(h), Taxpayer is required to issue Forms 1099 for commissions retained by its independent agents.

## "Look-through" Rule Applicable

### LTR 200115028

In LTR 200115028, the IRS determined that the Section 817 "look-through" rule applied to a mutual fund that invested in another mutual fund. Therefore, the accounts invested in would own a proportionate amount of the assets from the funds below.

Funds 1, 2 and 3 were used as investment vehicles for variable life and annuity contracts. Fund 1 is not currently sold on the open market and invests in Funds 2 and 3. All funds exist beneath Trust, an open-end management investment company and were considered separate companies. All three funds are considered Regulated Investment Companies (RICs).

Treas. Reg. Section 1.817-5(f) adds a "look-through" rule pertaining to the above regulations. If such rule applies, the interest in the RIC will not be considered an investment of the segregated asset account. Instead, a portion of the investment company assets will be treated as assets of the segregated asset account. The IRS determined that after Fund 1 invests in Funds 2 and 3, the interests in Funds 2 and 3 will still be held by the segregated asset accounts of an insurance company. Thus, the "look-through" rule would be satisfied.

## Blue Cross/Blue Shield Member Should Calculate Section 833 Deduction Separately

**FSA 200149009**

The IRS concluded that each Blue Cross/Blue Shield member of a consolidated group should separately calculate the income limitation on the Section 833 deduction.

Parent, an organization described under Section 833, is the common parent of a consolidated group that includes non-insurance companies. Parent acquired Sub, another Section 833 organization, on Date 2. For the period Sub was included in Parent's consolidated return, Sub reported a loss. The Parent consolidated group had positive taxable income.

Sub calculated the Section 833 deduction amount on a full-year basis, absent the taxable income limitation of Section 833(b)(4), and ratably allocated the amount to the short taxable year before its acquisition by Parent, and to the consolidated return year after its acquisition. Sub reported the figure allocable to the period while it was included in the consolidated return as its Section 833 deduction. The taxpayer

determined there was no Section 833(b)(2) limitation on the deduction. Sub contributed no taxable income to the group.

In coming to its conclusion, the IRS referred to Section 832(b)(1), Section 832(c)(10), and Section 833(b)(4). The IRS concluded that the computation of the amount of deduction and the taxable income limitation under Section 833 take into account only items that are attributable to the health-related business of the Section 833 organization. Because Sub did not have health-related taxable income for the taxable year, Sub is not entitled to a Section 833 deduction. Further, the Section 833 deduction is not listed in Treas. Reg. 1.1502-11 as one of the items calculated on a consolidated basis. Therefore, Sub and Parent must factor in the Section 833 deduction and limitation when determining separate taxable income under Treas. Reg. 1.1502-12.

The IRS also determined that, if the items necessary to calculate the Section 833 deduction cannot be determined, the Section 833 deduction should be determined on a full-year basis and then ratable allocated to each period, rather than allocating each item to a period and then calculating the allowable deduction separately for each period.

Finally, because each Section 833 organization calculates its own deduction and limitation separately as if it filed a separate return, the fact that the Sub has losses incurred in a separate return limitation year (SRLY) does not change Sub's Section 833 calculation. Therefore, in determining Sub's Section 833 deduction, Sub's health-related NOLs from prior years would offset any positive taxable income from health-related items for the year, even though SRLY would restrict the used of the NOL against the Parent group's consolidated taxable income.

# IRS Waives Failure of Policies to Satisfy Requirements of § 7702(a)

### PLR 200143008

The IRS waived the failure of certain life insurance policies to satisfy the requirements of Section 7702(f)(8).

Taxpayer B, a stock life insurance company, and Taxpayer C merged into pre-existing Parent F subsidiaries. After the initial merger Parent F began converting all Taxpayer policy data to its own computerized compliance testing system. The conversion process disclosed that some of Taxpayer's policies were not in compliance with the requirements of Section 7702(a), although Taxpayer had procedures existing that would have resulted in the policies complying with the statute.

The IRS ruled that rounding errors and other failures of policies to satisfy the requirements of Section 7702(a) are due to reasonable error, as the excess premiums paid were the result of clerical error in manual computations or were the result of data input errors. Taxpayer will, within 30 days, refund the excess premium with interest as of the date of refund.

### LTR 200150014 and LTR 200150018

The IRS granted two waivers under Section 7702(f)(8) for the failure of life insurance policies to meet the definition of a life insurance contract.

Taxpayers are both stock life insurance companies and both requests pertain to flexible premium universal life insurance contracts. In both cases the errors causing the failures to meet the definition of a life insurance contract were due to certain errors committed by employees. Computerized systems were used to correctly calculate the guideline premium limitations; however, personnel failed to follow procedures to refer amounts to the actuarial departments.

In addition, both taxpayers computed guideline premium limitations using Section 7702(c)(3)(B)(i) instead of Section 7702(c)(3)(B)(ii) to determine how to account for qualified additional benefits. The IRS waived the failure to comply, but did not agree with either taxpayer's conclusions as to the legal analysis of Section 7702.

# Chapter 9

## Multistate

2001 was a dynamic year for the insurance industry at the state and local level. Some states instituted premium tax rate reductions, while other states, starting to feel the economic effects of the past year, increased the amount of money an insurance company will pay the state either by reducing credits or eliminating them all together.

Some of the more substantial changes at the legislative level include CAPCO legislation in Colorado and Texas. Indiana reduced the premium tax rate, phased in over 5 years. Kansas changed the premium tax credit allowed for salaries paid to Kansas employees from 30% of salaries up to 1.25% of taxable premiums and from 15% of salaries up to 1.125% of taxable premiums. Maine has put in place a one-year assessment that increases the tax on the gross direct premiums for fire risks written in Maine from 1.4% to 1.8%. New Hampshire increased the rate of the Business Enterprise Tax from 0.5% to 0.75%, and the rate of the Business Profits Tax from 8% to 8.5%.

On the judicial side, while the cases were not high in number, they were certainly high impact. In the continuing saga *of Milwaukee Safeguard*, the Illinois Appellate Court ruled that insurance companies seeking a privilege tax refund must first show that they bore the burden of the tax and did not pass on the tax to their policyholders.[1] In addition, the Michigan Supreme Court reversed the earlier lower court's decision in TIG and ruled that the amendments to the retaliatory tax were constitutional and that the credits at issue could not be included in the Michigan side of the retaliatory tax calculation.[2] In another significant development the Texas Court of Appeals overturned the lower court's opinion and found that Texas could not include the internal rollovers in the premium tax base.[3]

[1] *Milwaukee Safeguard Ins. Co., v. Selcke*, No. 1-00-1973 (Ill. App. Ct. Jul 17, 2001)

[2] *TIG Ins. Co. v. Revenue Division, Dept. of Treasury*, No. 115915 (Mich. S.Ct. July 3, 2001)

[3] *All American Life Ins. Co. v. Texas Comptroller of Public Accounts*, No. 03-00-00427-CV (Tx. Ct. App. August 30, 2001)

# State-by-State Developments

## Alabama

Alabama House Bill No. 2118 amends the insurance code to require the Director of Insurance to examine the affairs of domestic insurers every five years. It replaces the requirement that such examinations be conducted every three years. It also imposes an annual assessment against domestic insurers for the purpose of paying the costs of conducting financial surveillance of domestic insurers. The assessment is based upon each insurer's total admitted assets as shown in its annual statement for the calendar year preceding the year in which the assessment is made.

## Arkansas

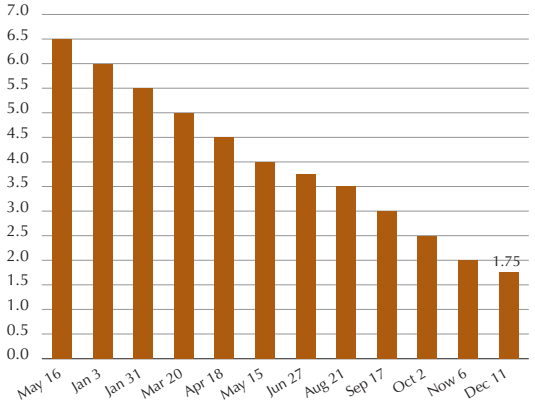
House Bill No. 2450 will modernize the insurance code to meet the requirements of the Gramm-Leach-Bliley Act and to meet the continuing NAIC requirements. Additionally, Ark. Code § 23-63-101, pertaining to the non-retaliation provisions of insurers who are owned more than 15% by Arkansas companies, is repealed and Ark. Code § 26-57-604 is amended to permit accident and health companies to apply for a credit for the non-commissioned salaries and wages of the insurer's Arkansas employees. The credit may be applied as an offset against the premium tax, but may only offset up to 80% of the tax.

In addition, House Bill No. 2489 amends various provisions of the insurance law to make it applicable to HMOs.

## Colorado

House Bill No. 1097 provides that any certified investor who makes an investment of certified capital will earn a vested credit against premium tax liability equal to 100 percent of the certified capital invested by the certified investor. Any premium tax credits not used by the certified investor in any single year may be carried forward and applied against the premium tax liabilities of such investors for subsequent calendar years. This bill also addresses the process for earning premium tax credits and provides a limitation on credits.

**FED RATE DECISIONS** *(percent)*




Source: CNN.com, December 11, 2001, "Fed cuts Rates"

## Connecticut

Senate Bill No. 1247 reduces the number of life and health guaranty fund assessment classes from three to two. In addition, this bill **removes** an insurer's ability to transfer any offset of premium tax liability to an affiliate.

## Delaware

House Bill 250 clarifies that retaliatory tax does not apply to premium tax credits for guaranty fund assessments.

## Florida

The Supreme Court of Florida found that surrender value proceeds paid to holder of a deferred annuity contract were in fact "proceeds from an annuity" within the meaning of the statute exempting the proceeds of annuity contracts from attachment, garnishment, or legal process in favor of any creditor.[4] The court found that such exempt proceeds include moneys received from surrendering an annuity contract prior to maturity. This decision could give rise to further debate in Florida (and possibly

[4] *Goldenberg v. Sawczak*, No. 00-1527 Supreme Court of Florida (May 3, 2001)

elsewhere) as to whether deferred annuities (i.e., Column 6 deposits) are to be considered annuity contracts rather than deposits.

In 2000, the Florida Circuit Court held that Continental Insurance Company ("CNA") miscalculated its retaliatory tax by including payments made by CNA for Workers Compensation Administrative Assessments during the calendar year 1995.[5] In reaching this conclusion, the court found that the holding in *Department of Revenue v. Zurich Insurance Company*,[6] is controlling. In *Zurich*, the court determined that Florida's Workers Compensation Administrative Assessment is a "Special Purpose Obligation" as the term is used in section 624.5091 of the Florida retaliatory tax statute. This statute provides that such non-property special purpose obligation payments are excluded from the computation of the retaliatory tax. The Florida District Court of Appeals heard oral arguments in late October. The parties do not expect a decision before January or February of 2002. Note that subsequent regulations published by the Florida Revenue Department support the inclusion of such assessments for years 1997 and thereafter.

## Hawaii

Senate Bill No. 1068 conforms Hawaii's licensing laws to the Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley Act or "GLBA"). This bill adopts the National Association of Insurance Commissioners ("NAIC") Producer Licensing Model Act that was created and approved by that organization in response to the GLBA mandates. This Act simplifies and organizes statutory language to improve efficiency and reduce costs associated with issuing and renewing insurance licenses.

## Illinois

Senate Bill No. 1176 requires all taxpayers with annual tax liabilities of $200,000 or more to make all tax payments by electronic funds transfer.

[5] The Continental Ins. Co. v. State of Florida Dept. of Revenue, (Fla. Cir. Ct. No. 98-3490)

[6] *Department of Revenue v. Zurich Insurance Co.*, 667 So.2d 365 (Fla. Ct. App. 1998)

An out-of-state company which owned insurance subsidiaries was not considered to be a holding company for Illinois income tax purposes and, thus, based on the facts, Illinois could not tax the income of the company or include it in a combined return.[7]

An Illinois circuit court ruled that an insurance company was not entitled to a refund of unconstitutional privilege taxes because the Director of the Department of Insurance's authority to issue tax refunds is limited by statute.[8] Because Nationwide did not pay the tax under protest, the funds were not held aside in a protest fund that could have been subject to repayment to Nationwide. The court found that the Protest Act (30 ILCS 230/2a.1) did not provide for the director to authorize refunds, which shows this was not the intent of the legislature. The court further added that the director could authorize refunds only in three circumstances: when there is a mistake of fact, when there is an error in calculation, and when there is an erroneous interpretation of the statute.

The Illinois appellate court has ruled that insurance companies seeking a privilege tax refund must first show that they bore the burden of the tax and did not pass on the tax to their policyholders.[9] A group of insurance companies incorporated outside of Illinois filed a complaint against the director of the Illinois Department of Revenue and the treasurer of the state of Illinois. The companies claimed that they were subject to an unconstitutional privilege tax that was not imposed on domestic insurance companies incorporated in Illinois. The trial court ruled in favor of the insurance companies and ordered remand for further proceedings.

On remand, the Department of Revenue argued the "pass-on" defense successfully, holding that in order for the plaintiffs to be entitled to a tax refund, they must show that they bore the burden of the tax and did not pass it on to their policyholders, thereby receiving a windfall. The Appellate Court held that the 'pass-on defense' applies as a matter of law in the instant case; since the pass-on defense has been raised by the defendants, the plaintiffs now have the burden of establishing that there

[7] *Cincinnati Casualty Co. v. Illinois Dept. of Revenue*, No. 00 L 50254 (January 17, 2001)

[8] *Nationwide General Ins. Co. v. Illinois Dept. of Revenue,* No. 00 MR 5 (February 27, 2001)

[9] *Milwaukee Safeguard Ins. Co., v. Selcke*, No. 1-00-1973, (Ill. App. Ct. Jul 17, 2001)

was no windfall; defendants did not waive the issue of windfall because the pass-on defense may be considered at the remedial phase of litigation; and further proceedings are appropriate with respect to determining the amount of windfall. The case has been remanded to determine the amount of any refunds.

### *DOR v. Gatsby Industries*

With captive insurance companies high on the Federal radar, the Illinois Department of Revenue (DOR) concluded in an administrative decision[10] that a Vermont captive insurance company that was not considered an insurance company for federal purposes was not an insurance company for Illinois state purposes. Thus, the company must be included in the parent's unitary group.

Gatsby Industries (Gatsby) formed Pennybacker Insurance Co. (PIC) as a captive under the laws of Vermont. Gatsby filed an Illinois unitary tax return for 1992 - 1994, excluding PIC. PIC filed a Vermont captive return and paid premium taxes to the state. Gatsby contended that since PIC was an insurance company under Vermont law, it should not be included in the unitary return and that by not considering a Vermont captive to be an Illinois captive would violate the Uniformity Clause of the Illinois Constitution of 1970. The administrative judge ruled that not being considered a federal insurance company prevented filing as an Illinois captive: "If the Internal Revenue Service determines that it is not valid entity for federal income tax purposes, it will not be recognized for Illinois income tax purposes."

## Indiana

House Bill No. 1150 reduces the insurance premium tax from 2% to 1.3% over a five-year phase-in period. The tax is reduced in 2000 to two percent (2%), for 2001, one and nine-tenths percent (1.9%), for 2002, one and eight-tenths percent (1.8%), for 2003, one and seven-tenths percent (1.7%), for 2004, one and five-tenths percent (1.5%), for 2005 and thereafter, one and three-tenths percent (1.3%).

[10] DOR v. Gatsby Industries Inc. IT 00-10 (May 16, 2000)

## Kansas

House Bill No. 2065 1) reduces the amount of the salary credit from 30% to 15%, and 2) reduces the extent by which the 2% rate can be reduced by application of the salaries credit from a maximum of 1.25% to 1.00% for companies that share the credit with affiliates. This bill was introduced in response to a report issued by the Kansas Legislative Division of Post Audit on February 22, 2001, which found that premium tax collections have decreased significantly since 1998.

## Louisiana

House Bill No. 264 authorizes local governments to contract with Louisiana Municipal Advisory and Technical Service Bureau for the collection of the local insurance premium tax. The Bill became effective June 26, 2001.

The United States Supreme Court denied Louisiana's request for *certiorari* in March.[11] Louisiana was appealing a 5th Circuit Court of Appeals decision holding that Louisiana's retroactive change of the second injury fund base from premium to paid losses was unconstitutional.

## Maine

Senate Bill No. 418 provides for a one-year assessment that increases the tax on the gross direct premiums for fire risks written in Maine from 1.4% to 1.8%.

## Maryland

House Bill No. 1424 provides a premium tax credit for project costs relating to certain economic development projects. To the extent the credit exceeds the amount of premium tax due it may be carried forward. Credit may not be claimed for the taxable year in which the economic development project is placed in service or during the first four subsequent tax years. In addition, House Bill No. 828 provides that following

[11] *U.S. Fidelity & Guar. Co. v. McKeithen*, 226 F.3d 412 (5th Cir. 2000) cert. denied ___ U.S. ___, 121 S.Ct. 1360 (2001)

an amnesty period which ended October 31, 2001, effective November 1, fines for non-payment or underreporting of state and local taxes will increase from $5,000 to $10,000 for each violation and provisions allow for up to five years in jail.

## Michigan

The Michigan Supreme Court overturned a lower court decision and held that Michigan's exclusion of payments made to private insurance associations and facilities from the calculation of its retaliatory tax does not violate the equal protection clause because the exclusion is rationally related to the legitimate state purpose of promoting the interstate business of domestic insurers.[12] The court found that the selective imposition of the retaliatory tax on foreign insurers incorporated in states with a heavier tax burden than that of Michigan indicates that the purpose of the legislation is to pressure those states to relieve the tax burden on Michigan insurers doing business in those states. Note that TIG filed a petition for *certiorari* with the United State Supreme Court on October 1, 2001 that was subsequently denied.

## Minnesota

Special Session House File No. 1 repeals the corporate franchise (income) tax on all domestic and foreign insurance companies paying the premium tax. Currently, only foreign insurers domiciled in states that impose retaliatory taxes on Minnesota insurers are exempt from this tax. The Bill also provides for quarterly estimated installment payments of insurance premium taxes, and that such prepayments must equal one-quarter of tax liability. Prior law required one-third of the tax liability to be made three times a year. The bill also changes the installment payment to which an overpayment on an insurance premium tax annual return can be applied from March 15 to April 1, consistent with the shift to quarterly payments. Finally, the bill extends the reduced 1.5% rate under the health care provider tax for two additional years (through 2003) and makes minor changes in the items subject to the MinnesotaCare taxes.

[12] *TIG Ins. Co. v. Revenue Division, Department of Treasury*, No. 115915 (Mich. S.Ct. July 3, 2001)

The Minnesota Tax Court concluded that CUNA, a mutual life insurance company that also sold casualty insurance failed to qualify as a mutual property and casualty company, and thus was not eligible to pay the premium tax on its non-life insurance premiums at a reduced rate.[13] The court held that an insurance company must sell both property and casualty insurance in order to be a mutual property and casualty company and that CUNA had failed to satisfy this statutory requirement. The court further concluded that the Minnesota Statute, allowing for reduced premium tax rates for mutual property and casualty companies, did not violate the Equal Protection Clause or the Uniformity Clause of the Unites States Constitution.

## Nebraska

Legislative Bill No. 433 provides a credit against the premium tax for 30% of costs incurred by the insurance company in providing child care services for children of employees for each taxable year, limited to 50% of the total premium tax liability.

## Nevada

Assembly Bill No. 134 modifies the limits on the fraud investigation assessment. Reinsurers would now be subject to a maximum assessment of up to $500, and direct writers will be subject to assessments between $500 and $2,000, depending on the amount of premiums written in the state. The cap on assessments was previously $500. (Status: 5/14/2001 Signed by Governor.)

## New Hampshire

House Bill No. 170 increases the rate of the Business Enterprise Tax from .5% to .75%, and the rate of the Business Profits Tax from 8% to 8.5%.

[13] CUNA Mutual Ins. Society v. Commissioner of Revenue, Nos. 7219, 7220, 7277, 2001 WL 1009290 (Minn. August 31, 2001)

## New Jersey

Assembly Bill No. 190 allows insurance companies to take a credit against their premium tax for 10% of the cost of commuter transportation.

A group of property and casualty insurance companies that are members of the Property-Liability Insurance Guaranty Association (PLIGA) unsuccessfully challenged the constitutionality of the Good Driver Protection Act of 1994 (GDPA), as applied to them, under the Contracts Clause and Equal Protection Clause of the New Jersey and U.S. Constitutions.[14] The property and casualty insurance companies contended that the GDPA violated their Contracts Clause rights because they were not parties to the settlement agreement and did not consent to the deferred repayment of the PLIGA assessments. However, their lack of involvement in the agreement had no impact on whether the GDPA impaired a constitutionally protected contract or contractual relationship because the Reform Act never conferred contract or contractual-type rights on the property and casualty insurers.

## North Carolina

Provisions of Senate Bill No. 1005 which would have subjected health maintenance organizations to the North Carolina premium tax, instead of the current income/franchise tax, effective for tax years beginning on or after January 1, 2001 was repealed by a subsequent bill. The subsequent bill institutes a 1.1% tax on HMO's effective January 1, 2003, dropping to 1% effective January 1, 2004 and after.

Additionally, Senate Bill No. 1005 provides a three-year sunset date for all newly enacted credits and eliminates a number of existing credits effective for tax years beginning on or after January 1, 2003. Credits eliminated as of January 1, 2003, include charitable contribution credits, health care and long term care insurance credits, and select industry credits.

[14] *Affiliated FM Ins. Co. v. The State of New Jersey*, No. A-7372-97T1 (NJ Sup. Ct. April 11, 2001)

## Pennsylvania

House Bill No. 2498 allows an insurance company that is a qualified business to apply for a job credit for all full-time jobs within a keystone opportunity zone or keystone opportunity expansion zone, for tax years that begin on or after January 1, 2001.

## South Dakota

Senate Bill No. 225 replaces the flat 2.5% premium tax rate on life insurance policies so that the first $100,000 of such policies will be taxed at the rate of 2.5%, and policies over $100,000 will be taxed at .08%. The bill also replaces the flat 1.25% rate on annuities so that the first $500,000 of consideration for such policies will be taxed at a rate of 1.25%, and the remainder will be taxed at a rate of .08%.

## Tennessee

House Bill No. 2038 & Senate Bill No. 2000, the "Fiscal Year 2001-2002 Budget Bill", provides for no new or increased taxes. Rather, the bill uses tobacco settlement money along with budget cuts to balance the budget. The legislature overrode the governor's veto of this bill. This marks only a pause in Tennessee's continued revenue shortfall woes as the bill uses one-time revenue to pay for recurring expenses. The budget proposals were of interest because they addressed several tax aspects including increasing the sales tax, introducing several types of income taxes, and expanding various taxes to currently untaxed segments of the state's economy.

## Texas

House Bill No. 3177 & Senate Bill No. 601 provide for a premium tax credit for investments in a certified capital company. In addition, Senate Bill No. 1690 clarifies that insurance companies that pay gross premium taxes are exempt from other taxes based on gross premium, but not from other state or local taxes unless specifically exempted. It also removes

the exemption for domestic insurance companies from any occupation or gross receipts tax. In addition, it clarifies the exemption applicable to title insurance companies and title agents.

House Bill No. 1495 allows available premium tax credits from assessments by the Life, Accident, Health and Hospital Service Insurance Guaranty Association to be transferred or assigned among or between insurers in the case of mergers, acquisitions, total assumption of reinsurance, or with approval from the commissioner.

The Comptroller assessed All American Life Insurance Company (All American Life) and several other insurance companies for additional premium and maintenance tax on internal rollover transactions.[15] All American Life and the other insurers appealed the lower court's decision in favor of the Comptroller to the Court of Appeals of Texas. The Court of Appeals reversed the judgement of the district court, and rendered judgement for All American Life and the other insurers. The Court of Appeals based its decision on one main issue: that the insurance companies did not "receive" or "collect" consideration (accumulation values of old policies) as the statutes plainly state. Because the statutes do not define "receive" and "collect," the Court of Appeals used the ordinary meaning of the words as found in a dictionary. From those definitions, the Court of Appeals deduced that both words connote taking or transferring in something from an external source. Since during an internal rollover transaction nothing is being brought in from outside, there are no premiums or considerations.

Prior to this latest decision, the Comptroller had proposed an amendment to the insurance tax rules that modifies the definition of premium considerations to include "internal policy rollover premiums." A hearing took place on April 10, 2001, in Austin, Texas. At the hearing, the Comptroller took public and industry feedback, and presented the definition of premium consideration as it is proposed. No decisions were reached due to continuing legal matters concerning the inclusion of internal rollovers in premium for tax and assessment purposes. In light of the decision above,

[15] *All American Life Ins. Co. v. Texas Comptroller of Public Accounts*, No. 03-00-00427-CV (Tx. Ct. App. August 30, 2001)

it is unclear whether the Comptroller will maintain her position regarding the proposed amendment to include internal policy rollover premiums in the definition of premium considerations.

As a result of an audit, the Comptroller assessed Dow Chemical Company for independently procured insurance taxes for the taxpayer's purchase of insurance from out-of-state insurance companies for taxpayer's property in Texas.[16] Dow paid the assessment under protest and filed suit in district court seeking a refund. The district court found in favor of the Comptroller. Dow appealed the decision to the Court of Appeals of Texas. The Court of Appeals reversed the judgement of the district court, and rendered judgement for Dow. The Court of Appeals based its decision two issues: **1)** that the notice requirements of the insurance code did not apply to Dow, and **2)** the "independently procured insurance" statute violated the McCarran-Ferguson Act. This decision is an affirmation of the continued validity of *Todd Shipyards*. The United States Supreme Court denied *certiorari* in late October.

## Utah

House Bill No. 205 reinstates the Employers' Reinsurance Fund Special Assessment beginning in January 1, 2002. All admitted insurers writing workers' compensation insurance and all authorized self-insurers are subject to an assessment of up to 2% of the total workers' compensation premium income received (plus deductible amounts) in the state during the prior calendar year, or for self-insurers, the amount calculated that is equivalent to the total workers' compensation premium income (plus calculated deductible amounts). This assessment is in addition to the regular workers' compensation assessment (premium tax), and can only be assessed if that assessment is insufficient to provide payment of benefits and expenses from the fund or to maintain the minimum approximate assets required by statute of the fund. This bill is repealed January 1, 2005. The last assessment for this purpose may not be imposed after December 31, 2004.

[16] Dow Chemical Co. v. Comptroller of Public Accounts, Hearing No. 03-00-00354-CV (Tx. Ct. App. January 25, 2001) cert. denied __ U.S. ___ (2001)

## Washington

As a result of an audit, the Department of Revenue (DOR) assessed First American Title Insurance Company (First American) additional tax on the portion of premiums retained by underwritten title companies (UTCs) as gross income for abstracting services.[17] First American provides the title insurance policies only, and the UTCs provide the title search, a process known as "abstracting," that culminates in a preliminary title report.

Under the contract with First American, the UTCs collected the premiums from the consumers, retained a portion as gross income for abstracting services, and paid the appropriate business and occupation tax (B&O tax). The remaining portion of the premiums was remitted to First American, who reported it as gross income for title insurance and paid the appropriate B&O tax. The Department of Revenue attempted to include the amount retained by the UTCs as gross income in the amount reported as gross income from title insurance by First American. First American paid the assessment and then sued for a refund. The Superior Court found in favor of the Department of Revenue and the Court of Appeals reversed. The Department of Revenue appealed to the State Supreme Court that affirmed the Court of Appeals' decision. The Court held that First American was entitled to a refund of the additional taxes paid, plus interest.

## West Virginia

House Bill No. 3009 and Senate Bill 664 change the tax base language from net direct premiums to taxable premiums, and then define taxable premium. The bills change the premium tax rate applicable to risk retention groups from .75% to 2%, and make risk retention groups liable for the Additional Premium Tax, under section 33-3-14a, at a rate of 1% and the Additional Fire and Casualty Premium Tax, under section 33-3-14d, also at a rate of 1%. Also, the five-year waiver and reduced tax rate provided to risk retention groups meeting certain investment requirements would be eliminated.

[17] *First American Title Ins. Co. v. Department of Revenue*; No. 69218-1 (Wash. S.Ct. July 26, 2001)

# Chapter 10

## Information Reporting

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

## Payments Made to Attorneys

The variety of payments made to attorneys that are reportable was greatly expanded by two provisions in the Taxpayer Relief Act of 1997.

First, Treas. Reg. §1.6041-3(c), which previously exempted payments made to corporations for services rendered from reporting, is no longer applicable to payments made to attorneys for legal services rendered. Therefore, payments made for services rendered by an incorporated attorney, or firm of attorneys, after December 31, 1997 must be reported on Form 1099-MISC as non-employee compensation in Box 7. Second, Section 6045 was created to specifically require the information reporting of "any payment made to an attorney in connection with legal services (whether or not such services are performed for the payor)" unless the payment is required to be otherwise reported. This requirement was also effective for payments made after December 31, 1997.

Insurance companies frequently settle claims by writing checks payable either to an attorney on behalf of their client, or jointly to an attorney and their client. Such payments that do not represent taxable income to the claimant are now clearly reportable to the attorney under Section 6045(f). However, the proper reporting of payments that represent taxable income to the claimant are not clear. Historically, there has been a debate as to whether such payments are reportable to the claimant. The new debate under Section 6045(f) questions to whom the payment is reportable - the claimant (Section 6041), the attorney (Section 6045(f)), or both?

The IRS issued proposed regulations under Section 6045(f) in May, 1999. These regulations are extremely broad. For example, they

- Require reporting for all payments in connection with "legal services" and provide an extremely broad definition of legal services that includes any services performed by or under the supervision of an attorney and
- Require reporting of payments made only to an attorney's client by that are delivered to the attorney.

Essentially, the regulations adopt the position that section 6045(f) is a duplicative reporting requirement, and based upon several examples in the proposed regulations, it would appear that it will be extremely common for payors to be required to issue two information returns with respect to any one payment.

> *The proposed regulations were originally intended to become effective with respect to payments made during the first calendar year beginning at least two months after the date of publication of the final regulations in the Federal Register. However, at a recent meeting of the Information Reporting Program Advisory Committee, the IRS noted that, in large part due to the many critical comments provided by the public on the proposed regulations, the IRS will issue a revised set of proposed regulations under Section 6045(f) before final regulations are published.*

Contrary to legislative intent, but consistent with other reporting to attorneys, payments of gross proceeds paid to attorneys are reportable for 2000 on Form 1099-MISC in Box 13, Coded A. **For 2001, payments of gross proceeds paid to attorneys will be reportable on Form 1099-MISC, in Box 14.**

## Reasonable Cause Procedures for Forms 1099-R

Revised IRS Publication 1586 provides the reasonable cause procedures applicable for missing and/or incorrect TINs reported on Forms 1099-R. The IRS proposed penalties for incorrect Forms 1099-R for the first time in 2001 (with respect to forms filed for 1999). Therefore, it is critical that payors ensure that they complied with these new requirements in 2001.

Pub. 1586 provides that when penalties are proposed for Forms 1099-R payors must satisfy the following requirements to meet reasonable cause for abatement of the penalty.

*Missing TINs.*

- An initial solicitation must have been made at the time the account was opened (in the absence of a response, withholding was required);
- If a TIN was not received as a result of the initial solicitation, a first annual solicitation is required by December 31 of the calendar year in which Notice 972-CG is received notifying the payor of the missing TIN;
- If a TIN is not received in response to the first annual solicitation, a second annual solicitation is required by December 31 of the calendar year immediately following the calendar year in which the original Notice 972-CG was received; and
- Once a TIN is received it must be included on all future Forms 1099-R filed for that payee.

*Incorrect TINs.*

- An initial solicitation must have been made at the time the account was opened;
- A payor must complete a first annual solicitation by the later of:
  - 30 business days from the date on the Notice 972-CG in which the IRS notifies the filer of the incorrect name/TIN combination, or
  - 30 business days from the date the filer received the Notice 972-CG;
- If the payee responds to the first annual solicitation within 45 days and furnishes a different name/TIN combination, any existing withholding election based on the prior name/TIN combination must be disregarded. In order to notify the payor regarding withholding from future designated distributions the payee must submit a new withholding election by completing a new Form W-4P. Any periodic payments made before receipt of the new withholding election must be subjected to withholding using the wage withholding rate for a married individual claiming three withholding allowances;

- If the payee does not respond within 45 days of the initial solicitation withholding must be taken from any subsequent payments that are designated distributions subject to withholding;
- Alternatively, upon receipt of the 972-CG, a filer may choose to disregard any prior withholding election made by a payee with a name/TIN mismatch in which case the payor should consider the payee as having no withholding election in effect until receipt of a new Form W-4P;
- A second annual solicitation is required if a filer is notified of an incorrect name/TIN combination in any calendar year following the first notification; and
- Once a new TIN is received it must be included on all future 1099-Rs filed for that payee.

## New Backup Withholding Rates

A provision in The Economic Growth and Tax Reconciliation Act of 2001 established new backup withholding rates effective with respect to payments made after August 6, 2001.

The new rates are:

- 30.5% for payments made on or after August 7th through the remainder of 2001;
- 30% for calendar years 2002 – 2003;
- 29% for calendar years 2004 – 2005; and
- 28% for calendar years 2006 and thereafter.

*New Form W-9*

*In December 2000 the IRS released a new version of Form W-9. The certification on the new form is different than that on prior Forms W-9. The certification was modified to include language necessary due to the new section 1441 regulations. It now includes the statement, "I am a US person (including a U.S. resident alien)."*

*In Announcement 2001-15, the IRS clarified that use of the new Form W-9 was optional until July 1, 2001. According to the Announcement, payors must use the revised form for all new solicitations after June 30, 2001. It would appear that payors may continue to rely on older version of Forms W-9 obtained before July 1, 2001 although the IRS has never clearly made this statement.*

*Another revision of Form W-9 is expected in 2002 that reflects the changes in the backup withholding rates discussed above.*

## Electronic Payee Statements

In February 2000, the IRS issued temporary and proposed regulations under Sections 6041 through 6053 setting forth procedures for permitting filers of certain information returns (Forms W-2; 1098-E, Student Loan Interest Statements; and 1098-T, Tuition Payment Statements) to furnish payee statements to recipients electronically as an alternative to furnishing them on paper. The regulations anticipate the use of a website based technology for delivery. While the forms to which these regulations currently apply are limited it is expected that they will be extended to other information returns in the near future.

Under the regulations:

- A recipient must give their consent to receive their information return electronically;
- All of the information required per the paper form must be provided in the electronic version of the form;

- The information return filer must "post" the information return by January 31; and
- The filer must provide notice to the recipient that the information has been posted on the website. This notice may be delivered by mail, e-mail, or in person. The notice must provide instructions on how to access and print the statement, and include the statement "IMPORTANT TAX RETURN DOCUMENT AVAILABLE" in capital letters.

Under the regulations, an information return recipient must affirmatively consent to receiving their statement in an electronic format. The consent cannot be given before certain disclosures are made to the recipient. The consent must be made electronically, in a manner that reasonably demonstrates that the recipient will be able to access the statement in the electronic format in which it will be furnished. Alternatively, the consent may be made in a different manner if it is confirmed electronically. In other words, for example, an employer cannot obtain a "consent" from an employee to furnish their Form W-2 electronically when the employee has no access to a computer or the employer's intranet website on which the employee's Form W-2 will be posted.

## TIN Matching Program

The IRS expects to make a widespread TIN Matching program available to all payors who file information returns reporting payments that are potentially subject to backup withholding in September 2002.

Under the program, payors will be able to submit TINs and corresponding payee names for matching against the IRS' records. The IRS will confirm whether a submitted payee name/TIN "match" exists. It will not, in the event of a mismatch, furnish the correct name/TIN combination. The TIN matching system will be accessible via either an interactive online session limited to 25 requests or electronic bulk requests limited to 100,000 requests per batch.

Payors wishing to participate in the program will have the opportunity to apply in June 2002.

*Treasury announced a launch of a new online tax payment system that will provide businesses and individuals with a convenient and supposedly secure means of paying their taxes. The new online service, located at* **www.eftps.gov**, *enhances the electronic federal tax payment system first introduced in 1996.*

Source: Tax Analysts, September 6, 2001

## Proposed Middleman Regulations

On October 17, 2000, Treasury issued proposed regulations under Section 6041, known as the "middleman regulations." These regulations address information reporting requirements for certain payments made on behalf of other persons, and payments to joint payees.

The regulations state that a payment made jointly to two or more payees may be fixed and determinable income to one payee even though it is not fixed and determinable income to another payee. Thus, when a payment from a health insurance company is made for services rendered to joint payees (e.g., a doctor and their patient), one of whom is the service provider (e.g., the doctor) an information return must be issued to the service provider to whom the income is fixed and determinable, even though the payment is not fixed and determinable to the other payee (e.g., the patient).

The regulations also state that a person that makes a payment on behalf of another person and performs a management or oversight function in connection with, or has a significant economic interest in the payment, the payor must report the payment under Section 6041. A management or oversight function is more than merely administrative or ministerial. Thus, a person that exercises discretion or supervision in connection with a payment is performing a management or oversight function and must issue a Form 1099, while a mere paying agent is not required to issue a Form 1099. A significant economic interest in a payment is an economic interest that would be compromised if the payment were not made. For example, a bank has a significant economic interest in a payment to a

contractor when damage occurs to property securing a mortgage held by the bank. Likewise, an insurance company most likely has an economic interest in property insured by the company.

The regulations also provide that a payor may, at its option, designate a paying agent to file information returns and backup withhold on its behalf by following the procedures set forth in Rev. Proc. 84-33, 1994-1 C.B. 502.

The regulations also require the reporting of gross, not net, payments. The regulations provide that amounts to be reported as paid to a payee are the gross amount for the payment before fees, commissions, expenses or other amounts owed by the payee to another person that have been deducted. For example, the regulations provide that a defendant that pays a settlement to a plaintiff and knows the amount of the plaintiff's attorney fees included in the payment would be required to report the gross payment to the plaintiff. The same result applies had the defendant issued separate checks to the plaintiff's attorney for the fee and the remainder to the plaintiff. In addition, the defendant in this latter instance will be required to report the gross amount paid to the attorney as such, even though the defendant knows the amount of the plaintiff's attorney fees.

These regulations are proposed to be applicable for payments made on or after the beginning of the first calendar year that begins after the regulations are published as final regulations.

*Obtaining Official IRS Reporting Information*

*The IRS operates a centralized call site to answer questions about information reporting. From 8:30 am to 4:30 pm (Eastern Standard Time), payors may call the IRS IRP call site at (304) 263-8700.*

# Appendix A

# Cases/Petitions

***American Electric Power v. United States*** 136 F. Supp 2d 762 (February 20, 2001) The District Court for the Southern District of Ohio ruled that the leveraged COLI program maintained by American Electric Power (AEP) was a sham in substance. Accordingly, the court disallowed claimed deductions for interest paid on policy loans.

***American Mutual Life Insurance Co., et al. v. United States***, 88 AFTR 2d. 2001-6127 (October 3, 2001) The Court of Appeals for the Federal Circuit affirmed a decision of the Court of Federal Claims, holding that a life insurer cannot assert the Section 111 tax benefit rule to exclude decreases in reserves from income.

***DOR v. Gatsby Industries Inc.*** IT 00-10 (May 16, 2000) The Illinois Department of Revenue (DOR) concluded in an administrative decision that a Vermont captive insurance company that was not considered an insurance company for federal purposes was not an insurance company for Illinois state purposes. Thus, the company must be included in the parent's unitary group.

***CM Holdings, Inc. et al. v. IRS;*** No. 00-3875 (July 30, 2001) Camelot Music filed a brief in the Third Circuit, arguing that its COLI program was not a sham for tax purposes.

***Kvaerner v. Staatssecretaris*** The European Court of Justice (ECJ) ruled that the Dutch tax authorities may tax insurance premiums paid by a U.K. corporation to a U.K. insurance company to cover its subsidiaries, some within the U.K. and others in the Netherlands.

***Lychuk v. Commissioner***, 116 T.C. 374 (May 31, 2000) The Tax Court ruled that a taxpayer who acquired and serviced multi-year installment contracts in the ordinary course of business must capitalize salaries and benefits directly related to its acquisition.

***Manufacturer's Life Insurance Company*** Canadian Federal Court of Appeals upheld a Tax Court ruling that stated that an insurance company was not required to include deferred realized gains on investments in taxable capital.

***Nicholas E. Eustace, et al. v. Commissioner*** T.C. Memo 2001-66 (March 20, 2001) The Tax Court, in agreement with the IRS, concluded that an S corporation, Applied Systems Inc. (ASI), was not eligible for the Section 41 research credit relating to insurance software.

***George Nichols III, in his capacity as Liquidator of Kentucky Central Life Insurance Company v. United States*** 260 F. 3d 637 (August 13, 2001) The United States Court of Appeals for the Sixth Circuit ruled that the Secretary did not exceed its authority under IRC Sections 1502 and 1503 in creating the anti-carryback legislation relating to life/non-life consolidated returns.

***Physicians Insurance Company of Wisconsin, Inc. and Subsidiaries v. Commissioner*** T.C. Memo 2001-304 (November 21, 2001) The U.S. Tax Court found that the taxpayer incorrectly reported its undiscounted unpaid losses for purposes of computing its deduction for losses incurred.

***In re Pioneer Hi-Bred International***, Inc. 238 F. 3d 370 (February 5, 2001) The Federal Circuit Court ruled that the disclosure in an SEC proxy statement of the tax consequences of a merger waived the attorney-client privilege for the underlying documents.

***Rite Aid Corp. v. United States***, 225 F.3d 1357 (July 6, 2001) The Court of Appeals for the Federal Circuit reversed a decision by the Court of Federal Claims and concluded that the duplicated loss factor was not within the authority delegated by Congress under Section 1502.

***United Dominion Industries v. Commissioner***, 121 S.Ct. 1934 (June 4, 2001). In an 8-1 decision, the Supreme Court reversed and remanded the Fourth Circuit in *United Dominion Industries v. Commissioner*, holding that an affiliated group's product liability losses (PLL) must be figured on a consolidated "single-entity" basis, and not by segregating PLLs on a company-by-company basis.

***United Parcel Service of America v. Commissioner*** 87 AFTR 2d 2001-2565 (June 21, 2001) The U.S. Court of Appeals for the 11th Circuit, in a 2-1 decision, sided with the taxpayer, finding that the taxpayer had sufficient business purpose to "neutralize any tax avoidance motive." The case was reversed and remanded to the Tax Court for consideration of the IRS's alternative arguments under Sections 482 and 845(a), which had not been addressed in the Tax Court's 1999 opinion (78 TCM 262).

***U.S. Freightways Corp., f.k.a. TNT Frieghtways Corp., and Subsidiaries v. Commissioner*** 270 F.3d 1137 (November 6, 2001) The Seventh Circuit Court of Appeals reversed and remanded the case to the Tax Court.

***Utica Mutual Insurance Company and Subsidiaries v. Commissioner of Internal Revenue*** Utica Mutual filed a petition with the Tax Court arguing that the IRS ignored a previous Consent Agreement in issuing deficiency notices regarding Section 832 unpaid losses.

***Winn-Dixie Stores, Inc. v. Commissioner***, 254 F.3d 1313 (June 28, 2001) The 11th Circuit Appeals Court affirmed the Tax Court ruling that Winn-Dixie was not entitled to deduct interest and fees incurred in borrowing against insurance policies that it owned on the lives of its employees. The Appeals Court concluded that there was no business need for the program, and the COLI program lacked economic substance to be respected for tax purposes.

## IRS Rulings/Procedures/Notices/FSAs

### Revenue Ruling 2001-31

The IRS concluded that it would no longer challenge captive transactions using the "economic family" theory. However, it stressed that such transactions would continue to be examined based on specific facts and circumstances.

### Revenue Ruling 2001-38

The IRS updated the prevailing commissioner's standard tables of mortality and morbidity set forth in Revenue Ruling 92-19.

### Revenue Procedure 2001-24

The Rev. Proc. provides procedures by which an insurance company may obtain automatic consent to change its method of accounting for certain cash advances on commissions paid to its agents from deducting a cash advance in the taxable year **paid** to the agent to deducting a cash advance in the taxable year **earned** by the agent.

### Revenue Procedure 2001-42

The Rev. Proc. extends the procedures previously put forward in Revenue Procedure 99-27 for obtaining a closing agreement to correct the "inadvertent non-egregious" failure to comply with the modified endowment contract (MEC) rules of section 7702A.

### Revenue Procedure 2001-60

Rev. Proc. 2001-60 prescribes the loss payment patterns and discount factors for the 2001 accident year. These factors will be used in computing discounted unpaid losses under Section 832 of the Internal Revenue Code.

### Revenue Procedure 2001-61

Rev. Proc. 2001-61 prescribes the salvage discount factors for the 2001 accident year. These factors will be used in computing estimated salvage recoverable under Section 846 of the Internal Revenue Code.

### Announcement 2001-98

The IRS issued final regulations on the requirements for excise tax returns, payments, and deposits, effective for calendar quarters beginning September 30, 2001.

### Announcement 2001-112

The IRS clarified that taxpayers affected by the September 11, 2001 Terrorist Attack may redesignate estimated tax payments as tax deposits to satisfy obligations to deposit employment taxes.

### Notice 2001-10

The IRS Notice requires a significant change in the taxation of split dollar life insurance policies.

### Notice 2001-11

The IRS issued special rules under the new withholding regulations for financial institutions organized under the laws of a U.S. possession (possessions financial institutions).

### Notice 2001-61

The IRS announced that it would grant disaster relief for taxpayers affected by the September 11, 2001 terrorist attacks.

### FSA 200105014

The taxpayer deducted the premium amounts paid from it and its subsidiaries to its wholly-owned insurance subsidiary. The IRS disallowed these deductions, concluding that the transactions did not constitute "insurance." Ultimately, the IRS recommended conceding the premium payment deductions from Subsidiaries to Insurance Subsidiary.

### FSA 200120004

The IRS concluded that an insurance company needed to chronologically trace its gross receipts from capital assets sales rather than choosing specific transactions when calculating the abnormal capital loss deduction amount under Section 832(c)(5).

### FSA 200125005

The IRS recommended that the brother-sister structure be conceded. While this FSA noted that no court had fully accepted the "economic family," it was decided prior to Revenue Ruling 2001-31 in which the IRS noted officially that it would no longer use the "economic family" theory in attacking captives.

### FSA 200125009

Taxpayer deducted the premium amounts paid to a sibling subsidiary of a common parent. The IRS did not disagree with the recommendation to concede the case.

### FSA 200143003

The IRS ruled that it may not correct an error in a closed tax year unless the Taxpayer's position is sustained in a determination for an open tax year.

### FSA 200144028

The IRS concluded that a life insurer may determine basis in a reinsurance ceding commission by using the Section 338 residual allocation method.

### FSA 200145004

The IRS supported the comments of the Appeals Court in the American Mutual case, that, if in fact no tax benefit is received, the tax benefit rule will be applicable.

### FSA 200148022

The IRS narrowly construed Rev. Rul. 57-747 and the statutory rule of construction in requiring the Taxpayer to issue Forms 1099 for commissions paid to independent agents.

### FSA 200149009

The IRS concluded that each Blue Cross/Blue Shield member of a consolidated group should separately calculate the income limitation on the Section 838 deduction.

### *Industry Specialization Program Coordinated Issue Settlement Program Guideline*

The IRS concluded that a change in Section 807(c) reserve items should be treated as a Section 807(f) basis adjustment, requiring amortization over ten years rather than a change in accounting method taken in full in the year of change.

### *Industry Specialization Program (ISP) Coordinated Issue Settlement Program Guideline*

The IRS released a Guideline which provided guidance to Appeals Officers regarding settlements relating to captive insurance companies.

## Private Letter Rulings and Technical Advice

**LTR 200111013** The IRS considered the reorganization of a mutual life insurance company into a stock corporation to be a Section 368(a)(1)(E) tax-free recapitalization.

**LTR 200114002** The IRS considered the reorganization of a mutual life insurance company into a stock corporation to be a Section 368(a)(1)(E) tax-free recapitalization.

**LTR 200115028** The IRS determined that the Section 817 "look-through" rule applied to a mutual fund that invested in another mutual fund. Therefore, the accounts invested in would own a proportionate amount of the assets from the funds below.

**LTR 200119039** The IRS determined that a motor vehicle protection company was considered an insurance company for federal income tax purposes.

**PLR 200121040** The IRS granted a Section 831(b) election revocation.

**PLR 200133020** The IRS granted a Section 831(b) election revocation.

**LTR 200138010** The IRS determined the motor vehicle protection plans provided by a company were considered to be insurance contracts and that the company is an "insurance company."

**PLR 200140057** The IRS concluded that certain extended service contracts are insurance contracts for federal tax purposes and that the Taxpayer is an insurance company under Section 831 of the Internal Revenue Code.

**PLR 200142014** In PLR 200121040, a taxpayer was given permission to revoke its Section 831 election for the 2001 tax year; however, the request for revocation of election for the 2000 tax year was denied.

**PLR 200143008** The IRS waived the failure of certain life insurance policies to satisfy the requirements of Section 7702(f)(8).

**LTR 200144001** The IRS considered the reorganization of a mutual life insurance company into a stock corporation to be a Section 368(a)(1)(E) tax-free recapitalization.

**LTR 200150014** The IRS granted waivers under Section 7702(f)(8) for the failure of life insurance policies to meet the definition of a life insurance contract.

**LTR 200150018** The IRS granted waivers under Section 7702(f)(8) for the failure of life insurance policies to meet the definition of a life insurance contract.

**TAM 200108002** The IRS concluded that the use of graded valuation interest factors to compute tax reserves under Section 807(d) was appropriate for structured settlements.

**TAM 200115002** The IRS reversed its historical litigating position and made several determinations on the Section 832 unpaid loss reserves.

**TAM 200147007** The IRS ruled that a foreign insurer may not rely on income reported on its NAIC annual statement to determine its effectively connected income.

**TAM 200149003** The IRS ruled that an insurance subsidiary that provides workers' compensation coverage for its sibling companies is an insurance company for tax purposes.

**ILM 200138014** The IRS concluded that it would be impermissible to utilize a net operating loss (NOL) carried forward from a Section 831(b) tax year to a Section 831(a) tax year due to reorganization.

## Regulations

**Proposed Section 41 Regulations.** The IRS issued proposed regulations on the research credit in order to lay to rest many of the disputes about whether research and experimentation expenses qualify for the credit.

**Proposed Section 1275(a)(1)(B)(ii) Regulations** The IRS issued proposed regulations, providing guidance as to whether certain annuity contracts issued by insurance companies would be excluded from the definition of a debt instrument under the original issue discount provisions.

**Final Section 6302 Regulations** The IRS issued final regulations under Section 6302 that permanently remove Federal Reserve banks as authorized depositories for federal tax deposits.

# Treaties

## United Kingdom

The new U.S./U.K. tax treaty, which was signed into law on July 24, 2001, contains a number of provisions applicable to the insurance industry including excise taxes, interest withholding, direct investment dividends withholding, and pension and retirement benefits.

# Appendix B

### Atlanta, Georgia

| | | |
|---|---|---|
| Julie Goosman | 678-419-1003 | julie.v.goosman@us.pwcglobal.com |
| Josie Lowman | 678-419-1612 | josie.lowman@us.pwcglobal.com |
| Sherrie Winokur | 678-419-1172 | Sherrie.Winokur@us.pwcglobal.com |

### Bermuda

| | | |
|---|---|---|
| Richard E. Irvine | 414-299-7136 | richard.e.irvine@bm.pwcglobal.com |

### Birmingham, Alabama

| | | |
|---|---|---|
| Terri Milstead | 205-250-8523 | terri.grasser.milstead@us.pwcglobal.com |
| Kurt Hopper | 205-250-8525 | kurt.w.hopper@us.pwcglobal.com |
| Karen Russell | 205-250-8550 | karen.russell@us.pwcglobal.com |

### Boston, Massachusetts

| | | |
|---|---|---|
| John Farina | 617-439-7391 | john.farina@us.pwcglobal.com |
| David Rudicel | 617-428-8721 | dave.rudicel@us.pwcglobal.com |
| David Wiseman | 617-428-8592 | david.wiseman@us.pwcglobal.com |

### Chicago, Illinois

| | | |
|---|---|---|
| Rob Finnegan | 312-298-3557 | rob.finnegan@us.pwcglobal.com |
| Craig Larsen | 312-298-5524 | craig.b.larsen@us.pwcglobal.com |
| Michael Natal | 312-298-4010 | michael.r.natal@us.pwcglobal.com |
| Joe Wallace | 312-298-2719 | joseph.p.wallace@us.pwcglobal.com |

### Dallas, Texas

| | | |
|---|---|---|
| Doug Monska | 214-754-5038 | doug.p.monska@us.pwcglobal.com |
| Patricia Falvey | 214-981-7154 | patricia.falvey@us.pwcglobal.com |

### Fort Worth, Texas

| | | |
|---|---|---|
| Chris Baraks | 817-870-5570 | chris.a.baraks@us.pwcglobal.com |
| Chuck Lambert | 817-870-5521 | chuck.lambert@us.pwcglobal.com |

### Honolulu, Hawaii

| | | |
|---|---|---|
| Wendell Lee | 808-531-3436 | wendell.k.lee@us.pwcglobal.com |
| Kent Tsukamoto | 808-531-3462 | kent.k.tsukamoto@us.pwcglobal.com |

### Indianapolis, Indiana

| | | |
|---|---|---|
| Mark Bilodeau | 317-453-4114 | mark.e.bilodeau@us.pwcglobal.com |
| Kevin Crowe | 317-453-4117 | kevin.p.crowe@us.pwcglobal.com |

### Kansas City, Missouri

| | | |
|---|---|---|
| David Kaseff | 816-218-1654 | david.kaseff@us.pwcglobal.com |

### Los Angeles, California

| | | |
|---|---|---|
| Michael Callan | 213-356-6039 | michael.f.callan@us.pwcglobal.com |
| Susan Leonard | 213-830-8248 | susan.leonard@us.pwcglobal.com |

### New York, New York

| | | |
|---|---|---|
| Karey Dearden | 646-471-7285 | karey.dearden@us.pwcglobal.com |
| Joseph Foy | 646-471-8628 | joseph.foy@us.pwcglobal.com |
| Richard Glaser | 646-471-7069 | richard.glaser@us.pwcglobal.com |
| Timothy Kelly* | 646-471-8184 | timothy.kelly@us.pwcglobal.com |
| Gayle Kraden | 646-471-5313 | gayle.kraden@us.pwcglobal.com |
| Stephen Lasota | 646-471-5172 | stephen.lasota@us.pwcglobal.com |
| Ed Markovich | 646-471-8152 | edward.markovich@us.pwcglobal.com |
| Ad Shuster | 646-471-3880 | addison.shuster@us.pwcglobal.com |
| Tim Williams | 646-471-5915 | tim.williams@us.pwcglobal.com |
| Jeffrey Fritsche | 646-471-3826 | jeffrey.fritsche@us.pwcglobal.com |

### Philadelphia, Pennsylvania

| | | |
|---|---|---|
| Richard Ashley | 267-330-6040 | richard.a.ashley@us.pwcglobal.com |
| Howard Braithwaite | 267-330-6115 | f.howard.braithwaite@us.pwcglobal.com |
| Joseph Waldecker | 267-330-6210 | joseph.b.waldecker@us.pwcglobal.com |

* Insurance Tax Leader, Americas

### St. Louis, Missouri

| | | |
|---|---|---|
| Byron Crawford | 314-206-8131 | byron.a.crawford@us.pwcglobal.com |
| Alan Fine | 314-206-8141 | alan.j.fine@us.pwcglobal.com |
| Jeff Kohler | 314-206-8159 | jeffrey.j.kohler@us.pwcglobal.com |
| Dave Monday | 314-206-8174 | david.r.monday@us.pwcglobal.com |
| Basil Pappas | 314-206-8183 | basil.d.pappas@us.pwcglobal.com |
| Thomas Wheeland | 314-206-8166 | thomas.f.wheeland@us.pwcglobal.com |

### Washington, D.C.

| | | |
|---|---|---|
| Elaine Church | 202-414-1461 | elaine.church@us.pwcglobal.com |
| Tony DiGilio | 202-414-1702 | anthony.j.digilio@us.pwcglobal.com |
| Ken Kies | 202-414-1300 | kenneth.j.kies@us.pwcglobal.com |
| James Kress | 202-414-1476 | james.w.kress@us.pwcglobal.com |

NYPD020752/200162 © 2002 PricewaterhouseCoopers. PricewaterhouseCoopers refers to the individual member firms of the worldwide PricewaterhouseCoopers organization. All rights reserved

Your worlds  Our people