PricewaterhouseCoopers

Continuing Developments in the Taxation of Insurance Companies

2002–The Year in Review

CONTINUING DEVELOPMENTS IN THE TAXATION OF INSURANCE COMPANIES

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

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

PricewaterhouseCoopers LLP

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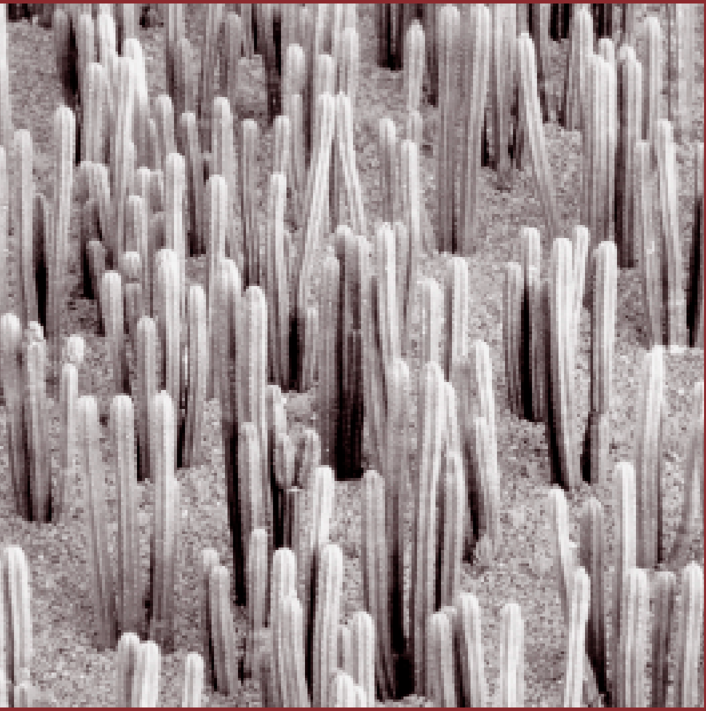


The Year in Review

In 2002 we learned that all "terrorists" weren't foreign nationalists determined to wreak havoc on our national security. Some were corporate executives who wreaked havoc on our financial security. The U.S. government, mobilized by the Bush Administration, spent 2002 focused on catching all these "terrorists," at home and abroad, and implementing new rules to prevent them from striking again.

For many Americans, concerns about the economy surpassed their concerns about national security. While a stimulus package was enacted early in the year, critics argued it, coupled with last years tax cuts, contributed to a $159 billion federal deficit in 2002.[1] Before the tax cuts could show any real effect, however, high profile accounting scandals rocked the U.S. markets and put additional strain on the U.S. economic recovery. In response, accounting oversight legislation was signed into law that outlined new governance requirements for corporate management and assigned additional oversight responsibilities to the Securities and Exchange Commission. By the end of the year, the economy was still sputtering and both the Administration and Congress were set to propose additional economic stimulus legislation.

[1] 2002 TNT 208-1, Office of Management and Budget.

Congress considered a slew of other tax related legislation during the year, little of which was passed. One hot topic was the continuing expatriation, or inversion, of U.S. domiciled corporations to international tax havens. Congress responded to the inversion issue by submitting no less than six bills with the purpose of eliminating the U.S. tax benefits of such inversions. The inversion controversy has prompted a review of the U.S. international tax regime, seen by many as restrictive and oppressive and not at all conducive to the new "world economy." Congress also pushed legislation to expand tax shelter disclosure and to penalize both taxpayers and promoters involved in tax shelter schemes. The majority of the proposed legislation stalled due to the division of control in the House and Senate; however, Congress did manage to pass terrorism insurance legislation, which had stalled all year, right before the end of its session.

Political turbulence resulted from and contributed to the economic and security concerns faced during the year. The November elections resulted in the Senate changing to a new 51 to 49 Republican majority, with Republicans also increasing their majority in the House. In addition, Senator Trent Lott and Congressman Richard Gephardt resigned their posts as party leaders. Treasury Secretary O'Neill, National Economic Council Director Lawrence Lindsey, and SEC Chairman Harvey Pitt resigned their positions. These changes, the continuing war on terrorism, the troubled U.S. economy, and the high profile accounting scandals contributed to a year of high political and economic uncertainty.

BALANCE OF POWER*	D	R
Senate (34 races)		
New tally	46	51
Previous	49	49
House (218 to control)		
New tally	201	225
Previous	208	223
Governor (36 races)†		
New tally	23	23
Previous	21	27

* Excludes independent, vacancies
† Vermont legislature to decide winner
Source: AP

The Continuing War on Terrorism

In the global war on terrorism, coalition forces led by the U.S. military ousted the Taliban and al Qaeda from Afghanistan; however, state enemy-number-one, Osama Bin Laden remains at large and by some accounts is re-grouping his forces. The continuing terrorist threat against U.S. worldwide interests caused the mobilization of the intelligence community. As a direct result of reports on the lack of communication and cooperation between federal agencies such as the FBI and CIA, the *Department of Homeland Security* was created, combining over 170,000 employees from twenty-two separate agencies into a single Cabinet-level department.

Insurers seized upon the continuing uncertainty in the economy and the prospect of future terrorist attacks to raise premium rates. In some cases, businesses saw their premium rates more than double while their corresponding coverage decreased. New and renewal policies included "terrorism exclusion" clauses. Terrorism specific insurance policies were written by few insurers and offered at often-prohibitive costs. Alternative risk management arrangements such as captive insurance proved to be a popular alternative to the traditional insurance model, prompting the IRS to release several captive insurance rulings at the end of the year and to end their "no rule" policy regarding such arrangements.

Insurance rates for large commercial properties in New York City rose more than 73% on average since the terrorist attacks, according to a survey by the city's comptroller. By comparison, insurance costs nationally rose 15% in 2001 and 30% in 2002, the survey said, citing data from the Insurance Information Institute.

"Insurance in New York Soared Since Sept. 11," *The Wall Street Journal*, November 14, 2002, No Page Citation.

Terrorism Risk Insurance

Given the instability in the world markets and recent years of underwriting losses, the premium rate increases and coverage exclusions were not unexpected. Many insurance companies already faced surplus strains due to recurring underwriting losses, and the continuing market decline compounded those surplus-strains. The prospect of war with Iraq and the potential retaliation against U.S. interests created an additional level of uncertainty in the insurance markets and further fueled the increase in insurance rates.

Enterprises that could not afford, or chose to forgo, policies that provided adequate terrorism insurance began to encounter financing problems. Some investors began charging higher rates for capital used to develop properties where there was an absence of terrorism insurance coverage on the property serving as collateral. In response, Congress passed the Terrorism Insurance Act of 2002 just before the end of its 107th[2] Session. The legislation requires insurers to cover terrorist events and directs the federal government to provide a reinsurance backstop to property casualty companies burdened with claims from qualifying terrorist events.

> ***"World Trade Center leaseholder Larry Silverstein suffered a major legal setback when a federal judge ruled that three of the 22 property insurers of the destroyed complex are bound by documents that define Sept. 11, 2001 attacks as a single event, requiring them to make only a single payment."[3] Mr. Silverstein has appealed the ruling.***
>
> "WTC Owner Appeals Ruling Calling Terrorist Attack One Event," Larry Neumeister, *Associated Press Newswires*, September 27, 2002.

Business and Accounting Scandals

The fall of Enron, WorldCom, and their accounting firm Arthur Andersen marked the high profile business scandals of the year. Continuing details emerged in 2002 regarding Enron's off balance sheet accounting of

2 HR 3210.

3 "Ruling Favors Insurers' Stance of Single Trade-Center Attack," Dean Starkman, *Wall Street Journal*, 9/26/02.

substantial liabilities. Information also emerged regarding the sale of Enron stock by executives at the time stock sales by employee retirement plans were frozen. Former Enron Chief Financial Officer Andrew Fastow was indicted on 78 felony counts, charged with devising a scheme with others to defraud the company, its shareholders and others.[4] As it turned out, Enron was the first of many.

As publicity regarding the Enron scandal began to wane, WorldCom dropped a bombshell. In the summer of 2002, WorldCom disclosed accounting irregularities related to $3.8 billion of incorrectly capitalized costs. Further probes into WorldCom's corporate accounting uncovered an additional $3.3 billion of irregularities and the company reported it might write off an additional $50 billion of intangibles.[5] Although it reported $107 billion in assets, $41 billion in debt caused WorldCom to become the largest company to file for protection under U.S. bankruptcy laws.[6]

As auditor for both Enron and WorldCom, Arthur Andersen was blamed for not forcing the companies to properly account for their financial activities. The destruction of Enron-related documents made a bad situation worse. On June 13th Arthur Andersen was found guilty in the State of Texas of criminal-obstruction, fined $500,000 and put on five-year probation.[7] After losing both its client base and its case in Texas, the firm discontinued all audit functions on August 31st, and the remaining Big Four accounting firms absorbed selected units.

While many felt the "destruction" of Andersen was inappropriate and excessive, the situation provided fodder for late night talk show hosts and advertising agencies. From Makers Mark bourbon's "disappears quicker than a big-five accounting firm", to Heineken beer's Christmas party where a blizzard resulted from mass document shredding, to Congressional inquiries where it was said of former Anderson partner David Duncan, "Enron robbed the

[4] "Enron CFO Fastow Indicted on 78 Counts of Fraud, Money Laundering, Obstruction," *BNA Daily Tax Report*, 11/1/02.

[5] "WorldCom finds another $3.3B in errors", CNN.com, 8/8/02.

[6] "WorldCom files for Bankruptcy", CNN.com, 7/22/02.

[7] "Andersen Fined $500,000, on Probation for Five Years in Enron Obstruction Case," *BNA Daily Tax Report*, 10/17/02.

bank, Arthur Anderson provided the getaway car and they say you were at the wheel,"[8] Andersen was a ripe target.

> ***Insurance claims filed under Directors and Officers policies by both Enron and WorldCom are being fought by their insurers due to the fraudulent nature of the actions underlying those claims. In addition, the nature of these events has prompted some to call for mandatory "audit insurance" for all publicly traded companies.***
>
> "Andersen, Meet Aetna. What's the best way to prevent future accounting scandals? Audit Insurance." Daniel Gross, *Slate*, 11/12/02, http://slate.msn.com; "Insurers Expected to Try to Deny WorldCom Officers' Coverage," Christopher Oster, *Wall Street Journal*, 7/1/02; "Two Insurers Seek Right to Challenge Claims from Enron Lawsuits," *Wall Street Journal*, 2/22/02.

The collapse of Enron alone produced investment losses across the insurance industry totalling $3 billion.[9] Once held as a secure, high quality stock, corporations' investment accounts across the world were impacted and individual investors' portfolios and retirement plans were decimated. The widespread impact and high profile nature of these scandals created an environment whereby Americans' focus was now directed not only at the risk of terrorist attacks from afar, but threatened economic security at home.

Sarbanes-Oxley

In response to the corporate governance concerns highlighted by the business and accounting scandals during the year, Congress passed new laws in an attempt to allay those concerns. The Sarbanes-Oxley Act provided for the creation of a federally appointed Public Company Accounting Oversight Board charged with establishing audit, independence, and ethics standards for public corporations and their auditors.[10] The legislation also imposed restrictions on corporate audit committees and prompted their additional involvement in corporate accounting oversight.[11]

[8] "Fired Andersen Partner Refuses to Testify on Enron," Kevin Drawbaugh and Susan Cornwell, *Reuters*, 1/24/02.

[9] "What Can Insurers Do to Clean Up the Corporate Governance Mess," Robert P. Hartwig, *National Underwriter*, 6/24/02.

[10] H.R. 3763.

[11] "Auditing the Audit Committees," Jonathan Weil and Dennis Berman, *Wall Street Journal*, 12/9/02.

Moreover, the Act provided guidelines to determine permitted activities for accounting firms that audit public companies, prohibiting many of the consulting services historically practiced by accounting firms. By year end each of the Big Four accounting firms had divested their consulting operations. Tax services provided by these firms are generally considered part of the audit function. In further support of tax services, research sponsored by the American Accounting Association indicated that financial statement restatements are inversely proportional to the amount of fees paid for tax services provided by the auditor.[12]

> ***Participating in a PricewaterhouseCoopers sponsored webcast, Michael Oxley elaborated that, "Congress did not intend to restrict accounting firms from selling tax services." Noting that "Congress determined that tax issues were part and parcel of the traditional audit function" and that "there was no evidence in our hearings that the tax function was untoward or somehow led to fraud."***
>
> "Oxley Says Governance Law Does Not Seek to Ban Tax Services," Jack Duffy, *Bloomberg News*, 12/9/2002.

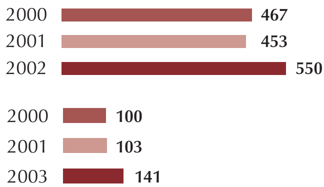
The SEC has been charged with enforcing the primary provisions of the Sarbanes-Oxley Act; however, internal troubles and the lack of funding have cast doubt on the ability of the agency to perform that function. Although the SEC received funding of at least $567 million for the fiscal year beginning October 1 (a 29% increase over the prior year), that funding fell well short of amounts requested by SEC advocates in Congress, and may not be adequate to enforce the Sarbanes-Oxley provisions.[13] In addition to the potential funding problems, Harvey Pitt, the SEC's embattled Chairman, was prompted to step down prior to year-end. Pitt's lack of disclosure and involvement regarding his appointments to the Public Company Accounting Oversight Board drew enough controversy to eliminate his effectiveness as leader of the Agency.

[12] File No. S7-49-02, memorandum to the U.S. Securities and Exchange Commission from William Kinney (University of Texas), Zoe-Vonna Palmrose (University of Southern California), and Susan Scholz (University of Kansas), 1/7/03, http://www.sec.gov/rules/proposed/s74902/wkinney1.

[13] "New Accounting Board Faces Same Old Problem," Greg Farrell, *USA Today*, 10/28/02.

MORE WORK FOR SEC

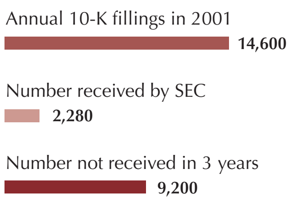
The securities and Exchange Commission faces an increasing workload



Civil and administrative enforcement actions begun in each fiscal year ending September 30:

Enforcement actions involving financial disclosure violations:

...but agency remains short-staffed



About 100 accountants are responsible for examining tens of thousands of fillings by more than 17,000 companies each year. With its current staff, the SEC cannot examine all corporate annual reports once every three years as a new federal law now requires.

Greg Farrell, "New Accounting Board Faces Same Old Problem," *USA Today*, October 28, 2002, Page 1B.

Economic Troubles

In addition to the scandals discussed above, there were several other high profile bankruptcies during the year including K-Mart, United Airlines, and USAir. A cycle of bankruptcies and stock declines fed upon itself and caused significant rating downgrades in the insurance industry. In September, Fitch Ratings downgraded 35 insurance companies in a single day.[14] At the end of October, property-casualty insurers held \$8.8 billion of corporate securities of "troubled" issuers as rated by Moody's Investor Services, Inc., representing 2.9% of the industry's capital.[15]

[14] "Annuities Firms See Ratings Drop," Bridget O'Brian, *Wall Street Journal*, 10/7/02.

[15] "Some Bets May Come Back to Haunt Insurers," Christopher Oster and Henny Sender, *Wall Street Journal*, 10/30/02.

TROUBLE ON THEIR HANDS *(in millions)*

WoldCom	$1,761
Tyco Intl.	1,295
Qwest Communications	933
Georgia Pacific	342
Williams Cos.	326
Gap	324
Corning	316
Lucent Technologies	277
Cablevision Systems	245
Nortel Networks	214

Property-casualty insurance companies are the largest holders of the bonds and stocks of companies that Moody's Investors Service calls "troubled credits" Here are some of those holdings

Christopher Oster and Henny Sender, "Some Bets May Come Back to Haunt Insurers," *Wall Street Journal*, October 30, 2002. Page C1.

The Dow Jones Industrial Average opened the year at 10,021 with a high in March of 10,728 and a low in October of 7,197. The unemployment rate rose to 6%[16], equalling the highest rate in eight years, while consumer confidence hit a nine year low in October.[17] Meanwhile decreasing federal revenues led to federal deficit projections until at least 2006. "The nation's ten-year budget surplus, projected at $5.61 trillion just 18 months ago, has all but disappeared because of lagging tax collections and increased spending to counter terrorism."[18] The Administration's answer to the growing crisis was to invoke both monetary and fiscal policies. The Federal Reserve attempted to spur the economy and to prop up the markets by lowering interest rates, dropping the Fed Funds rate to 1.25% in November, the lowest rate since 1961.[19] The Bush Administration continued to promote fiscal stimulus through tax cuts; Reaganomics was back in vogue.

> ***America can celebrate Tax Freedom Day on April 27, 2002. That is two days earlier than in 2001 and four days earlier than in 2000. "Two factors are combining to make the average American tax burden lighter in 2002," said economist Scott Moody, "federal tax reductions and a slower economy."***
>
> "Tax Foundation Release on 2002 Tax Freedom Day," *Tax Notes Today*, April 10, 2002, 2002 TNT 70-53.

16 "Jobless Rate rose to 6% in November; 8 year high", Daniel Altman, *New York Times*, 12/7/02.

17 "Consumer Confidence Plummets - Index's Drop to 9-Year Low Gives Fed Policy Makers More Reason to Cut Rates," Greg Ip and Sholnn Freeman, *Wall Street Journal*, 10/30/02.

18 "10-Year Surplus 94% Less than 2001 Estimate," Jim Drinkard, *USA Today*, 8/28/02.

19 "Fed Cuts Key Rate by One-Half Point in Aggressive Move", Richard Stevenson, *New York Times*, 11/07/02.

A Year of Government Changes

The November elections resulted in Republican dominance of both the House and Senate and were the first midterm elections since the Roosevelt Administration where the sitting Administration's party added to their representation in both houses of Congress.[20] The poor showing by the Democrats prompted the resignation of Richard Gephardt from the Minority Leader position. California Representative Nancy Pelosi, the first female to hold a leadership position, replaced him.[21] Republican Senate Leader, Trent Lott, also stepped down as a result of bad publicity over remarks that appeared to be racially offensive. Mr Lott was replaced by Tennessee Senator Bill Frist.

Changes in the Administration were also significant and notable. President Bush received resignations from Treasury Secretary Paul O'Neill, SEC Chairman Harvey Pitt, and his chief economic advisor, National Economic Council Director Lawrence Lindsey. It was rumored that Secretary O'Neill was not on-board with President Bush's tax-cuts-to-spur-the-economy theory due to concerns about the potential deficits they would create. Bush's appointments, John Snow former CEO of CSX to take over at Treasury and William Donaldson to chair the SEC, are expected to be confirmed in their roles[22] and charged with "polishing and adding form to the economic tax package"[23] that will be a cornerstone of Bush's re-election campaign.

Democratic campaigning for the 2004 Presidential election particularly focused on domestic issues. "It's the economy stupid," a phrase which followed the former President Bush into retirement has come back to taunt his son. Al Gore surprised many when he announced that he would not run for President in 2004. The early front-runners from the Democratic nomination include Senators John Kerry from Massachusetts and Joseph Lieberman from Connecticut. Although Bush has been very successful in maintaining his popularity through his efforts in the War on Terrorism, domestic issues will likely be the defining factor of the next election.

[20] "Bush Firms His Grip on Power," David Rogers, Shailagh Murray, and Greg Hitt, *The Asian Wall Street Journal*, 11/8/2002.

[21] "Pelosi Sweeps Past Frost in Bid To Lead House Democrats in 108th," *BNA Daily Tax Report*, 11/12/02.

[22] "Brookings Analysts Survey New White House Economic Team", Patti Mohr, 2002 TNT 241-2.

[23] Id.

Outlook for 2003

Economic Stimulus

Wary of comparisons to his father's presidency, widely seen as too focused abroad and not focused enough at home, the President has recently turned his focus inland with a new economic stimulus policy. The plan as released early in 2003, $674 billion in tax cuts over ten years, has already sparked debate. The centerpiece of the plan, the elimination of income taxes on stock dividends, has prompted attack by political opponents that the plan is proof positive that the Bush Administration is most interested in helping the rich. The debate to come was evidenced by the following diverse comments:

Bush "has put forward an irresponsible, ineffective, ideologically driven wish list that is oblivious to the particular problems our economy is facing."

Joe Lieberman, Connecticut Senate Democrat and 2004 Presidential Hopeful [24]

"This is the type of bold action needed to jump-start the stagnant U.S. economy."

Thomas Duersterberg, President of the Manufacturers' Alliance/MAPI [25]

"Throughout the economic downturn, the president has been AWOL. So it is outrageous that he is trying to pass off another tax cut for the rich as a boost to the economy."

John Sweeney, President of the AFL/CIO [26]

"This package would provide 23 million small business owners with an average tax cut of $2,042. No amount of class warfare can convince Main Street that that's a bad thing."

Jack Faris, President of National Federation of Independent Business [27]

In addition to the dividend exemption, the Bush plan accelerates the tax rate reductions from the 2001 tax cut package, increases child tax credits, accelerates marriage penalty relief, increases the amount of capital outlays able to be immediately expensed and prevents plan beneficiaries from paying AMT. If enacted, these provisions would be retroactive to the beginning of 2003.[28]

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[24] "Reactions to president's plan," *USA Today*, 1/8/03

[25] Id.

[26] Id.

[27] Id.

[28] "Tax-cut plan designed for 2004 returns," Judy Keen, *USA Today*, 1/8/03.

House Democrats attempted to pre-empt Bush's stimulus package by releasing their own tax cut proposal at the end of 2002. Costing a one time estimated expense of $136 billion in 2003, their package was focused on short term tax relief, targeting the middle class and small businesses. The Democrat plan provides for immediate $300 refund checks to be issued to all taxpayers, increases the amount of capital outlays able to be immediately expensed, accelerates depreciation expense, and extends unemployment benefits.[29]

Tax Reform

In remarks to the Tax Executives Institute in December, U.S. Assistant Treasury Secretary Pam Olson identified the challenges the U.S. tax system poses to the competitiveness and efficiencies of U.S corporations and the priorities for tax reform.[30] Ms. Olson detailed the negative impact of the outdated U.S. International Tax regime on the competitiveness of U.S. businesses in the global economy, focusing on Subpart F and the foreign tax credit rules.

> ***"We have a tax code that has not kept pace with the globalization that has transpired over the last 40 years. It is time for us to reconsider the rules based on today's realities and the future unfolding before us."***[31]
>
> Pam Olson

Ms. Olson also noted that Congress and Treasury will continue to show a united front in addressing the underlying reasons for the expatriation of U.S. corporations. In that vein, Republican Congressional leaders have specifically indicated that the inversion legislation that did not pass in 2002 will be re-proposed in 2003. Her discussion progressed to the Treasury's move to compel voluntary tax shelter disclosure and desire for legislation that would provide for uniform disclosure of tax shelters.

[29] Id.

[30] "Remarks to the Tax Executives Institute," Pam Olson, PO-3701, 12/18/02.

[31] Ibid.

> *"One thing I have become convinced of since joining Treasury is the importance of acting even without a legislative mandate. We don't always need laws to tell us the difference between right or wrong or to tell us what we ought to do. Consequently, we are exploring what the IRS and Treasury can do to implement registration on a voluntary basis."*[32]
>
> Pam Olson

Republican Congressional leaders have also indicated that the tax shelter legislation that provided penalties on taxpayers and promoters and that did not pass in 2002 will be re-proposed in 2003.

Ms. Olson also addressed overall tax simplification and the clarification of rules relating to R&E and capitalization, indicating that the simplification and clarification of tax laws is necessary for corporate efficiencies and accurate compliance.

> *"This is surely not a tax system anyone would set out to create, but it is the system that has evolved over time. Let's face it. We have reached the point where our tax system is held together by chewing gum and chicken wire. Moreover, a lot of the chewing gum and chicken wire was applied in haste, not strategically. It is time for us to clean house."*[33]
>
> Pam Olson

Cognizant that reform must ensure that trade-offs tied to the economic dependence on the current tax system must be considered, Treasury's goals with respect to simplification are to develop a system that is simple and easy to understand, with reasonable filing and record-keeping requirements, and non-intrusive tax administration, among other characteristics.

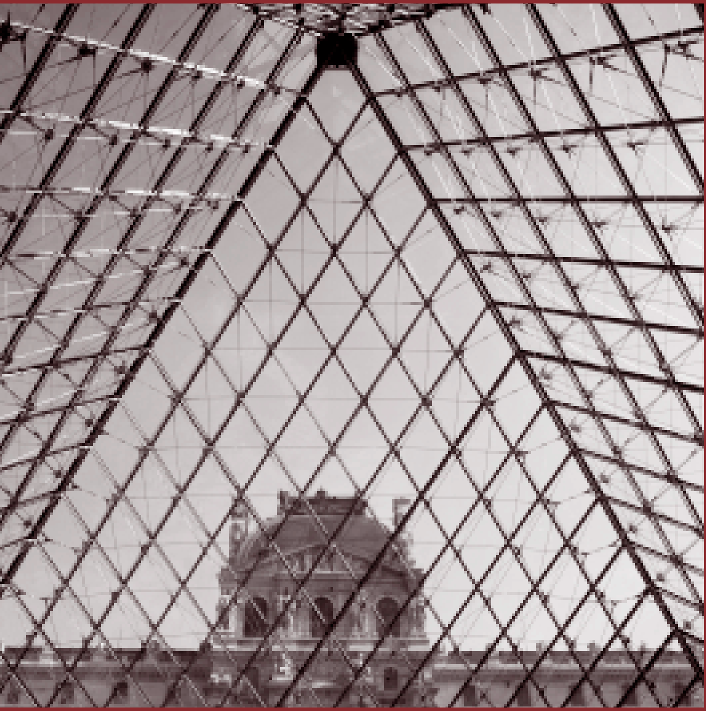
[32] Ibid.

[33] Ibid.

While not yet addressed in a public forum, tax reform specific to insurance companies has also been considered. Treasury representatives have indicated an interest in replacing the income tax on non-life insurance companies with a new premium tax regime, similar to that imposed by states. The proposal has already seen resistance from insurance companies, who fear that such a tax would place an unfair burden on insurers an could be easily manipulated to increase that burden.

Republicans and Democrats agree that outdated provisions in the U.S. tax system must be rectified. Both groups generally espouse the limitation on inversions, eliminating the inequities in the U.S. international tax law, and the overall simplification of the Tax Code. The trick in 2003 will be for Republicans and Democrats to agree on how best to restore economic growth and the role tax stimulus may play. With Republicans now in control of both the Executive and Legislative branches of government, the Bush plan is likely to receive significant attention and much of the legislation proposed in 2002 will have new life in 2003. Moreover, taxpayers should not expect that control by the Republicans will guarantee anything, as the new "moderates," both Democrat and Republican, will be wild cards in this Congress. The Administration and Congress must work together if the U.S. is to successfully navigate the continuing war on terrorism, the fallout from business and accounting scandals, and the troubled economy.

Chapter 2



2002 Tax Legislation

As has increasingly become the norm, the 107th Congress introduced an avalanche of legislation but enacted little of it. Moreover, little of the legislation introduced was even brought to the floor for a vote. The most debated legislation introduced in 2002 focused on corporate responsibility, terrorism risk insurance, homeland security, so-called "inversion" transactions, and tax shelters. A large number of bills addressing traditional corporate tax issues were introduced; however, such issues received little attention. The notable exception was the 2002 economic stimulus package.

Tight margins of control during the 2002 Congress stymied productivity. As early as July many were prophesying a lame duck session, with members of Congress leaving legislative items unattended in order to focus attention on the November 5 elections. Unable to resolve differences on several bill packages, Congress passed only a few resolutions including an extension of budgetary enforcement mechanisms, a defense appropriations bill, and a continuing resolution to fund the government before leaving for the Fall recess.

The November elections resulted in a new Republican majority in the House and Senate. When members of Congress returned on November 12, both the Homeland Security and Terrorism Risk Insurance bills were passed with little of the fanfare and heated debate that had surrounded them all year.

Enacted Legislation

Economic Stimulus

Job Creation and Worker Assistance Act of 2002 – H.R. 3090

In one of Congress's few efforts to work together, Republicans from the House of Representatives and Democrats from the Senate approved the "Temporary Extended Unemployment Compensation Act of 2002," a $42 billion stimulus package. Passing 417 to 3 in the House and 85 to 9 in the Senate, the bill was signed by President Bush on March 9, 2002.

Although much of the $42 billion package paid for special bonus depreciation rules, unemployment assistance and tax breaks for New York areas damaged during September 11, it also allocated $9 billion to a five-year extension of the Subpart F exception for active financing income, $2.1 billion to a five-year carryback for net operating losses, and $165 million to a temporary suspension of the reduction of deductions for mutual life insurance companies.

SUBPART F

Under general Subpart F rules, U.S. shareholders of a controlled foreign corporation cannot defer U.S. tax on certain income earned by the CFC whether or not such income is distributed to the shareholders. Temporary exceptions from Subpart F apply with respect to certain income derived in the active conduct of an insurance business. The stimulus bill extended the temporary exceptions for five years. In addition, the provision permitted taxpayers in certain circumstances to establish that the reserve for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract, subject to IRS approval through the advance rulings process or in published guidance.

> ***A tax break signed into law earlier this month by President Bush could end up paying once highflying companies – and costing taxpayers – billions of dollars. The new tax provision, part of the stripped-down economic stimulus package, is intended to aid corporations that paid hefty tax bills during the recent go-go years, but now are struggling amid the economic downturn. Plenty of businesses that have fallen on hard times – from tech companies to airlines – are bound to take advantage of the new legislation to bring in much needed cash, tax and accounting experts say.***
>
> "Ailing Companies May Get a Windfall Through Tax Break Signed by Bush,"
> Janet Whitman, *Wall Street Journal*, March 20, 2002, Page B5.

NET OPERATING LOSSES

The bill temporarily extended the general NOL carryback period to five years for NOLs arising in taxable years ending in 2001 and 2002. In addition, the provision allowed the offset of 100 percent of a taxpayer's alternative minimum taxable income resulting from AMT NOL carrybacks arising in taxable years ending in 2001 and 2002 and AMT NOL carryforwards to these years.

The extension of the NOL carryback period from 2 to 5 years does not apply to the Section 810 operating loss deductions of life insurance companies. Congress previously ignored the life industry when it changed the net operating loss carryback and carryforward provisions in 1997. At that time, it was expected that Congress would issue a technical correction; however, no such correction has been enacted.

DIFFERENTIAL EARNINGS AMOUNT

Section 809 requires mutual life insurance companies to reduce policyholder dividend deductions by the differential earnings amount. The stimulus bill provides a zero rate for both the differential earnings rate and recomputed differential earnings rate, or "true-up," for taxable years beginning in 2001, 2002 or 2003. The change effectively allowed mutual life insurance companies a full deduction for policyholder dividends.

In a letter to Pamela Olsen, Acting Assistant Secretary for Tax Policy, Department of the Treasury, the Mutual Tax Committee requested permanent repeal of Section 809. The Mutual Tax Committee stated that Section 809 was based on competitive industry circumstances that no longer exist, and on tax theory that has been determined to be invalid by a wide array of distinguished tax policy experts and by the Treasury department.

"Treasury FOIA Letters," *BNA Daily Tax Report*, June 13, 2002.

Corporate Governance

Sarbanes-Oxley Act of 2002 – H.R. 3763

The House and Senate overwhelmingly approved the "Sarbanes-Oxley Act of 2002" that addressed deceptive accounting and management practices. The bill covered several areas of corporate governance by establishing an accounting oversight board, detailing restrictions on services provided by auditors, and outlining corporate responsibilities, penalties, and financial disclosures. President Bush signed the bill on July 30, 2002.

Public Company Accounting Oversight Board

The bill established a "Public Company Accounting Oversight Board" to oversee the audits of public companies. The Board is not a government agency, but will register public accounting firms, establish auditing, quality control, ethics, and independence standards, and conduct inspections of registered public accounting firms.

Services Provided by Auditors

The bill addressed the services that can be provided by auditors. The list of prohibited activities is virtually the same as that currently codified in the SEC's rules on independence and includes bookkeeping or other services related to the accounting records or financial statements of the audit client; financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; internal audit outsourcing services; management functions or human resources; broker or dealer, investment adviser, or investment banking services; and legal services and expert services unrelated to the audit.

The legislative history of this provision suggests that Congress did not wish to depart from the current SEC definitions of these terms, which should continue to apply to the statutory list of prohibited services, at least until the SEC or the new Board determines to revisit the issue. Expert services, however, were not defined in the final SEC rule and may be defined by the Commission or the Board in later rulemaking.

The bill provided that a public accounting firm may provide non-audit services, including tax services, not specifically prohibited. However, as part of the broader responsibilities placed on audit committees, the Act required that both auditing and non-auditing services, including Statutory audits, be pre-approved by the audit committee, with a de-minimus exception for audit committee approval of non-auditing services.

It seems clear that Congress intended that public companies would continue to have the ability to obtain from their auditors non-audit services, including tax and certain types of actuarial services, not specifically prohibited by statute, SEC rule, or any subsequent rules that may be adopted by the new Board.

Corporate Responsibility

Provisions of the bill relating to corporate responsibility prohibited the listing of any security of an issuer that is not in compliance with the standards set forth in the bill. Other provisions required the executive officer to certify that the financial statements do not contain any untrue statements of material facts or do not omit any material facts.

Provisions of the bill relating to corporate responsibility state that any "issuer having reincorporated or having engaged in any other transaction that resulted in the transfer of the corporate domicile… to outside of the United States" is not exempt from the provisions of corporate responsibility. This provision followed on the heels of several attempted Congressional mandates targeting inverted corporations and mandated the application of the law to U.S. corporations that have reincorporated abroad.

> ***Insurers and financial services companies should reevaluate their risk management structures and strive for a more practical and holistic approach, a report published jointly by PricewaterhouseCoopers and the Economist Intelligence Unit advises. Those connected with the study said that insurers were lagging in some respects when it came to risk management. The report, "Taming Uncertainty: Risk Management for the Entire Enterprise," highlights the range of risks facing financial institutions, from high to low probability and from the quantifiable to the intangible. The report, PwC said, was also designed to help industry leaders understand the risks they face and align risk management strategies with corporate objectives.***
>
> "Insurers Lag in Risk Management: PwC," Caroline McDonald, *National Underwriter*, July 22, 2002, Page 26.

Penalties

The bill instituted CEO and CFO penalties where an issuer restates financial statements as a result of misconduct and also established pension black-out periods for insider trading. The bill required that attorneys report evidence of material violations of securities law to the CEO or chief legal counsel of the company.

The legislation also included a provision that expressed the "sense of the Senate" that the Federal income tax return of a corporation should be signed by the CEO. This provision, though not binding, indicated that Congress expects senior executive officers to take more responsibility for all areas of corporate financial management, including Federal taxation.

Financial Disclosures

The bill required enhanced financial disclosures including disclosures concerning the accuracy of financial statements, off-balance sheet transactions, codes of ethics, and pro-forma figures. Also included were enhanced conflict of interest provisions for executives and analysts.

Effective Date

The bill was effective generally upon enactment; however, certain provisions of the bill depend upon the creation of the Public Company Accounting Oversight Board and the establishment of rules that must be approved by the SEC. At the close of 2002, the SEC had chosen a Board and the Board was functioning to create rules as authorized by the bill. After rules are approved, public accounting firms will have 180 days to register with the Board. It is expected that at that time, provisions of the bill relating to services provided by auditors will become effective.

> ***William Webster's passive approach as audit-committee chairman of the virtually insolvent U.S. Technologies Inc. attracted criticism and ultimately prompted him to withdraw from his post as head of the government's new accounting-industry oversight board, explaining that he stood by his board work but his role in the new position would generate distraction.***
>
> "Panel Members Attract Scrutiny Over Roles at Other Companies," Jonathan Weil, *Wall Street Journal*, December 9, 2002, Page C1.

Terrorism Risk Insurance

An attempt to pass a terrorism risk insurance bill in late 2001 was unsuccessful despite the many economic arguments put forth by both insurers and insureds. In March 2002, Congress held hearings to determine if there were true economic consequences to be considered. Among the witnesses testifying at the Financial Services Subcommittee on Oversight and Investigation was Mark J. Warshawsky, Treasury's Deputy Assistant Secretary for Economic Policy. Noting that most insurers had excluded coverage on damage resulting from acts of terrorism, Mr. Warshawsky stressed the need for the restoration of private insurance coverage for terrorism and briefly outlined the consequences that the September 11 terrorist attacks had on the reinsurance, property and casualty, and worker's compensation insurance industries.

In late August the Senate passed federal risk insurance legislation. President Bush met with lawmakers twice in October to urge them to resolve differences between the House and Senate surrounding the award of punitive damages. Eventually, House Republicans and Senate Democrats were able to agree on the issue of punitive damages and sent the bill to the President upon their return from the November elections.

Terrorism Insurance Bill – H.R. 3210

The "Terrorism Risk Insurance Act of 2002" was identical to the version previously passed by the House of Representatives (H.R. 3210) and was signed by President Bush on November 26, 2002.

The Act established the Terrorism Insurance Program to provide coverage to the property casualty insurance industry with respect to "acts of terrorism".

The federal share of insured losses equals ninety percent of the amount of losses in excess of the insurer deductible amount. Insurer deductibles are computed by applying a specified rate, increasing from seven to fifteen percent over the life of the program, to direct earned premiums in the year prior to the insurable event.

Generally, neither the federal government nor insurers that meet their deductible will be liable for payment of losses that exceed an aggregate of one hundred billion dollars for each plan year.

An "act of terrorism" must result in claims exceeding five million dollars. The Terrorism Insurance Program does not cover claims arising from wars, reinsurance claims, or life and health claims. Additionally, to fund the program and recoup payments made under the program, the Secretary of the Treasury may impose a policyholder premium surcharge, not to exceed three percent of the premium charged under the policy. All property casualty insurers are required to participate in the program, though it is unclear whether and how captives and certain workers compensation funds will participate.

While the bill is only a temporary measure, sunsetting at the end of 2005, it should help to allay the uncertainty regarding the availability of catastrophic coverage and to help stabilize the cost of insurance and related financing issues.

> ***Moody's Investors Service Inc. downgraded $4.5 billion of commercial mortgage-backed securities because owners of some high-profile skyscrapers haven't been able to buy terrorism insurance. A Fitch Ratings managing director said a legislative deal would be an "extremely positive development" that could lead to a ratings upgrade.***
>
> "Deal Is Close on Terrorism Insurance, John D. McKinnon," David Rogers, and Dean Starkman, *Wall Street Journal*, October 18, 2002.

Homeland Security

The Homeland Security Act of 2002 – H.R. 5005

On November 25, 2002, President Bush signed H.R. 5005, "The Homeland Security Act of 2002." The Act established the Cabinet-level Department of Homeland Security through the combination of twenty-two separate agencies and their 170,000 employees. Former Pennsylvania governor Tom Ridge was appointed to be Secretary of the new Department.

While the primary provisions of the Act did not have direct tax implications, one provision was noteworthy. The Act provided that, in general, the Secretary may not enter into any contract with a corporation that qualifies as a domestic inverted corporation, where inversion takes place following the date of enactment. The fact that the general prohibition was enacted into law did not bode well for inverted corporations. It was a sign that certain members of Congress would be persistent in their goal to reprimand those so-called "un-patriotic" companies who moved their domicile offshore. The prohibition of the Department's dealings with inverted corporations was, however, muted by an amendment providing for waivers of the prohibition. While the impact of that provision on the insurance industry is likely to be minimal, the implications of the "message" sent were clear.

> ***With major corporate responsibility legislation passed, elected officials are turning to a new target – business tax evaders – in a scramble to convince voters they are cracking down on corporate wrongdoing. While debating a less-noticed provision in the president's homeland security proposal (H.R. 5005), 110 Republican members defied their party's leaders to confront another brand of questionable behavior: companies locating overseas to escape U.S. taxes.***
>
> "Congress Targets Tax Havens," Juliet Eilperin and Jonathan Weisman,
> *Washington Post*, July 30, 2002, Page A1.

Legislation Not Enacted But Noteworthy to Insurers

Inversions

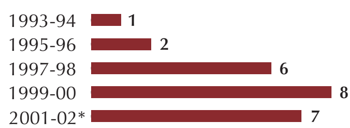
The issue of corporate "flight" has been a point of contention for three years now. When Congress held hearings on the subject in 1999, the argument focused primarily on insurers. During 2002, however, the attack on those who had redomesticated broadened to encompass all industries. Many in the insurance industry took comfort in the fact that they were no longer the only target, and that additional legislation sent many new lobbyists to the halls of Congress to plead their case.

No less than four House and two Senate inversion bills focused on amending the tax code to make corporations in corporate expatriation transactions taxable as domestic corporations. In addition to the bills, various amendments to such other bills as the "Care Act of 2002," the "Small Business and Farm Economic Recovery Act," and the "Energy Policy Act of 2002" were offered in the House and Senate that either mirrored the bills introduced or were very similar. While the "Energy Policy Act of 2002" was passed, the inversion amendments were withdrawn. Ultimately none of the bills or amendments became law in 2002.

In general, the bills and amendments introduced would have treated acquiring foreign corporations in corporate expatriation transactions as though they were domestic corporations, and therefore subject to U.S. tax on their income. Typically, a corporate expatriation transaction was defined as any transaction where a "nominally foreign corporation" acquired substantially all of the properties held directly or indirectly by a domestic corporation and where immediately after the transaction more than 80 percent of the stock of the acquiring corporation was held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation. Most of the bills also called for a lower stock ownership test if the "nominally foreign corporation" did not have substantial business activities in the foreign country in which it was created and if the principal market for the public trading of the stock of the corporation is in the United States.

FEW FIRMS LEAVE USA

The number of U.S. companies reincorporating in foreign countries, mostly Bermuda and Cayman Islands, is small but on the rise:



* Through June 2002

Angela Wyatt, "Don't Fault Firms for Fleeing Cumbersome U.S. Tax Code," *USA Today*, August 25, 2002, Page A2.

Corporate Patriot Enforcement Act of 2002 – H.R. 3884

Few members of Congress were as active on the inversion front as Representative Richard Neal of Massachusetts. Rep. Neal first introduced the "Corporate Patriot Enforcement Act of 2002" in early March 2002; however, he reintroduced the bill as an amendment to several other legislative proposals during the course of the 2002 legislative session. Rep. James Maloney (D-CT) filed a petition to discharge H.R. 3884 from committee and garnered 187 signatures, short of the 218 required to bring the bill to the floor. H.R. 3884 would have treated an acquiring foreign corporation in a corporate expatriation transaction as a domestic corporation, to prevent corporations from avoiding the U.S. income tax by reincorporating in a foreign country.

A Bill to Treat Nominally Foreign Corporations as Domestic Corporations – H.R. 3857

Rep. Scott McInnis, (R-CO) introduced a bill virtually identical bill to Rep. Neal's but applied more objective criteria to the 50 percent stock ownership test. The bill never came to a vote.

Patriotic Purchasing Act of 2002 – H.R. 4831

Representative Jim Turner (D-TX), joined by Reps. Richard Neal (D,MA), Earl Pomeroy (D-ND), Lloyd Doggett (D-TX) and numerous others introduced H.R. 4831, "The Patriotic Purchasing Act of 2002," which would have made any foreign corporation that entered into a corporate expatriation transaction ineligible to be awarded government contracts. H.R. 4831 was referred to the House Committee on Government Reform, but did not come to a vote during 2002. However, the Homeland Security Act contained a provision similar to H.R. 4831.

> ***"It is little wonder why we smile, we found an offshore domicile. We like the sunshine on our backs, and it is perfect for escaping tax. We're all moving to Bermuda, ride moped and scooter. It is a nice vacation, and we like the tax evasion."***
>
> Lyrics from the annual New York Financial Writers Association "Financial Follies," Tim Herman, "Taxpayers Could Save by Waiting," *Wall Street Journal*, December 5, 2002.

American Competitiveness and Corporate Accountability Act – H.R. 5095

House Ways and Means Chairman William Thomas (R-CA) was joined by Reps. Nancy Johnson (R-CT), Amo Houghton (R-NY), and Jim McCrery (R-LA) in introducing H.R. 5095, the "American Competitiveness and Corporate Accountability Act." The bill would have imposed a three-year moratorium on inversions (by treating acquiring foreign corporations as domestic corporations) and would have made numerous changes in the U.S. taxation of multinational corporations.

A Bill To Treat Nominally Foreign Corporations As Domestic Corporations – S. 2050

The late Senator Paul Wellstone (D-MN), introduced S. 2050, which would have treated foreign corporations that acquired the stock or property of a domestic corporation as a domestic corporation if the shareholders of the transferring (or transferred) domestic corporation acquired more than 50 percent of the stock (by vote or value) in the acquiring foreign corporation. The bill did not come to a vote.

> ***An extremely tight midterm election suddenly took on an extra dimension of national drama in late October. A plane crash killed Senator Paul Wellstone, his wife and daughter, and five others and evoked memories of a similar accident that took the lives of Missouri Gov. Mel Carnahan and his son Randy two years ago. Mr. Wellstone had been locked in a neck-and-neck race for a third term with Republican Norm Coleman, the 53-year-old former mayor of St. Paul.***
>
> "Passing the Torch: In Minnesota Race, Democrats Balance Grief and Power," Tom Hamburger and Jackie Calmes, *Wall Street Journal*, October 28, 2002, Page A1.

Reversing the Expatriation of Profits Offshore Act (REPO) – S. 2119

On the Senate side, Rep. Neal was joined in combating inversion transactions by Finance Committee Ranking Member Chuck Grassley (R-IA), and Chairman Max Baucus (D-MT) who introduced a bill to rein in corporate inversions

The "Reversing the Expatriation of Profits Offshore Act," (REPO) would have treated a foreign corporation that acquired a domestic corporation in an inversion transaction as a domestic corporation for U.S. tax purposes. In addition, the bill would have amended Section 845(a) to allow the IRS to reallocate or recharacterize income, deductions, assets, reserves, or credits between related parties to reflect the proper amount, source, and character of the taxable income (prior law referred to source and character, but not amount). The Senate Committee on Finance reported favorably on the bill in June 2002, but no other action was taken.

> ***Citing the growing prospect of comprehensive federal tax legislation, Stanley Works said Aug. 1 it has withdrawn its plans to improve its competitive position by reincorporating in Bermuda. "Our ability to compete is being undermined by the U.S. tax code, which is archaic in today's global market," Stanley CEO John M. Trani said. "We have been asked by the congressional leadership on both sides of the aisle to support their efforts toward rectifying this situation by enacting legislation that will create a level playing field for companies incorporated in the United States," Trani said. "We have honored their request and the ball is now in their court."***
>
> "Stanley Works Announces Withdrawal Of Plan to Reincorporate in Bermuda," Martha Kessler and Katherine M. Stimmel, *BNA Daily Tax Report*, August 5, 2002, Page G-1.

Tax Shelters

In a continuing effort to dissuade other individual and corporate tax shelter schemes, two additional pieces of legislation were proposed during the year. These bills exemplified the shift in focus of both Congress and Treasury to require the disclosure of "tax shelter" transactions as opposed to the traditional hide and seek played by taxpayers and the IRS.

Tax Shelter Transparency Act - S. 2498

Senator Max Baucus (D-MT) introduced the "Tax Shelter Transparency Act" on May 9, 2002. Senator Baucus' bill differentiated tax shelters into "Reportable Transactions" and "Listed Transactions." The authority to identify reportable and listed transactions was delegated to the Secretary of the Treasury.

The bill provided for penalties on both the taxpayers involved in undisclosed "tax shelter" transactions and the promoters of such transactions. Taxpayers that failed to disclose reportable transaction would be subject to a penalty of up to $100,000, and taxpayers that failed to disclose listed transactions would be subject to a penalty of up to $200,000. The bill would have also increased up to 30% the accuracy-related and substantial understatement penalty percentages related to reportable and listed transactions. Penalties on promoters for failing to maintain tax shelter lists reached as high as the greater of $200,000 or 75% of the gross income derived from the promoting such transactions.

The bill was reported from the Committee on Finance and placed on the legislative calendar, but never put to a vote.

Tax Haven and Abusive Tax Shelter Act of 2002 - S. 2339

Senator John Kerry (D-MA) introduced the "Tax Haven and Abusive Tax Shelter Act of 2002" on April 26, 2002. Senator Kerry's bill put forth a definition of "economic substance" and also differentiated tax shelters into "reportable" and "listed" transactions to be determined by Treasury. The bill also required additional reporting, and limited benefits with respect to income deferral and tax credits derived from foreign corporations located in identified tax havens.

Under the bill, transactions would have economic substance only when the taxpayer's economic position changed in a meaningful way and there was a substantial non-tax purpose, where the transaction provided reasonable means of accomplishing such purpose. The penalty on the understatement of tax resulting from transactions without economic substance would increase from 20% to 40%. In addition to the accuracy-related penalty, the failure of a taxpayer to disclose a reportable transaction would be subject to an additional penalty equal to the greater of 5% of the tax benefit from such transaction or $100,000. For the failure to disclose a listed transaction, the penalty would equal the greater of 10% of the tax benefit from such transaction or $100,000. Persons promoting transactions without economic substance or promoting and failing to properly record listed and reportable transactions would be subject to a penalty of up to 100% of the gross income derived by the promoter.

The bill was referred to Senate Committee on Finance, but never sent to the floor.

Other Federal Legislation

Tax Simplification Act of 2002 – H.R. 5166

As in the past, House Ways and Means committee member, Rob Portman (R-OH) introduced the "Tax Simplification Act of 2002" (H.R. 5166), containing provisions for the elimination of limitations on the consolidation of life and non-life companies and an increase in the exclusion from income for the cost of employee group term life insurance. The bill incorporated the majority of H.R. 909, introduced March 7, 2001 by Rep. Phil Crane. In addition, the proposed legislation included a provision that would have waived the five-year waiting period for reconsolidation and the 35 percent loss limitation rules. The bill did not come up for a vote.

2003 Treasury, Postal Service, and General Government Appropriations Bill – H.R. 5120

The House of Representatives passed 308-121 the 2003 Treasury, Postal Service, and General Government appropriations bill. While the bill reported by the House Appropriations Committee included an amendment to refuse government contracts to companies headquartered in tax haven countries, the amendment was removed after the House approved a rule to strike non-germane provisions of the bill. The Senate approved a bill that was substantially similar to the House bill, and at the conclusion of 2002, both bills were awaiting conference.

> ***The first hearing on optional federal chartering revealed the stark differences between the life insurance and property-casualty insurance industries that are certain to make enactment of OFC legislation that much harder than if the industries were unified. The widespread view is that some type of consensus will have to be achieved before any OFC legislation can move ahead.***
>
> "Optional Federal Chartering Opponents Duel at Congressional Hearing," Steven Brostoff, *National Underwriter*, June 10, 2002, Page 34.

Exemption from Tax for Small P&C Insurance Companies – S. 2084

Senator Christopher Bond (R-MO) introduced S. 2084, which would have increased the $350,000 and $1.2 million exemption thresholds for small property and casualty insurance companies to the level they would have been in 2002 if the 1986 tax code had included an inflation adjustment. Accordingly, the tax exemption would have applied to P&C insurers with premiums that do not exceed $551,000, and the alternative for taxation of investment income would apply to companies with premiums above $551,000 but not more than $1,890,000. Rep. Jim Nussle (R-IA) had previously introduced an identical bill (H.R. 1908) in June 2001. Neither bill came to a vote in 2002.

Chapter 3

Reserves

Determining the appropriateness of tax reserves continues to be a difficult issue for insurers. The dual goals of reasonable and deductible tax reserves challenge companies and remain an area focus for the IRS. Three appellate courts ruled on the area of tax reserves in *Best Life Assurance Company of California,*[34] *Minnesota Lawyers Mutual Insurance Company,*[35] *and Principal Mutual Life Insurance Company*.[36] The taxpayers won on appeal in Best Life, but lost in Minnesota Lawyers Mutual and Principal Mutual Life.

Additionally, Treasury proposed regulations under Sections 807, 811, 812, and 817A, while the IRS issued Rev. Rul. 2002-6 regarding a change in the computation of existing life insurance reserves, and Rev. Proc. 2002-74 in which it announced that for purposes of loss reserve discounting under Section 846 and salvage discounting under Section 832, it will issue composite discount factors for accident years not generally disclosed on the annual statement. Finally, for those hanging on to the hope that the tax benefit rule would provide relief for older reserve releases, those hopes were dashed by the U.S. District Court in Equitable Life Assurance v. United States.[37]

[34] *Best Life Assur. Co. of California v. Commissioner*, 281 F.3d 828 (9th Cir. 2002).

[35] *Minnesota Lawyers Mut. Ins. Co. v. Commissioner*, 285 F. 3d 1086 (8th Cir. 2002).

[36] *Principal Mut. Life Ins. Co. v. United States*, 295 F.3d 1241 (Fed. Cir. 2002).

[37] *Equitable Life Assurance Society of the United States v. United States*, S.C. N.Y., No. 00 Civ. 4066 (RMB), 2/6/02.

Best Life Assurance

The Ninth Circuit Court of Appeals affirmed the Tax Court in *Best Life Assurance*,[38] holding that the term "unpaid losses" in Section 816(c)(2), as understood in the life insurance industry, includes only unaccrued unpaid losses.

On its income tax returns, Best applied the Section 816(a) formula to its returns and determined that its ratio of qualifying reserves to total reserves exceeded 50 percent. In making this determination, Best excluded accrued unpaid losses from the "unpaid losses" portion of the denominator figure of the reserve ratio. The IRS argued that Best should not have excluded its accrued unpaid losses. The Tax Court agreed with Best. Relying heavily on the Seventh Circuit's decision in *Harco Holdings*,[39] the court determined that "the term 'unpaid losses' has acquired a specialized meaning in the (life and accident and health insurance) industry that includes only… unaccrued unpaid losses."

> ***Investors are largely shrugging off a massive waive of fourth-quarter charges to boost claims reserves in the property-casualty insurance sector. So far this quarter, more than three dozen insurers have reported, or say they will report, a total of $5.4 billion in charges mostly related to either restructuring or claims reserves.***
>
> Christopher Oster, "Property-Casualty Insurers' 4th-Period Charges to Boost Claims Reserves Don't Faze Investors," *Wall Street Journal*, February 26, 2002, C2.

Minnesota Lawyers Mutual

The Eighth Circuit Court of Appeals affirmed the Tax Court in *Minnesota Lawyers Mutual*,[40] ruling that Minnesota Lawyers' (MLM) unpaid loss reserve estimates were not "fair and reasonable."

MLM was formed in 1981 to provide affordable legal malpractice insurance. In response to an unstable financial situation, in 1985, MLM doubled the

[38] *Best Life Assur. Co. of California v. Commissioner*, 281 F.3d 828 (9th Cir. 2002).

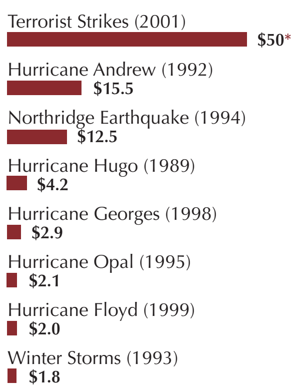
[39] *Harco Holdings*, Inc. v. United States, 977 F.2d 1027 (7th Cir. 1992).

[40] *Minnesota Lawyers Mut. Ins. Co. v. Commissioner*, 285 F. 3d 1086.

minimum reserve for each individual claim, and established a new bulk reserve referred to as an "adverse loss development" (ALD) reserve. MLM claimed tax deductions for unpaid losses in the same amounts reported in its annual statements, which included an actuarial certification of the reasonableness of unpaid loss estimates. The IRS concluded MLM overstated its unpaid losses and assessed tax deficiencies. The Tax Court subsequently ruled that MLM had overstated its reserves. The Eighth Circuit upheld the Tax Court's reasoning that MLM's actuary's reports were prepared *after* MLM had already determined the amount of unpaid loss reserves to report in its annual statements and tax returns. Since MLM arrived at its estimates without the benefit of an actuary's reports, the tax court did not err in discounting the actuarial opinions.

RISKY BUSINESS *(in billions)*

With terrorism losses so steep for insurers, some are looking for help from 'game theory' which is used to predict simple results like the outcome of a pistol duel. To the right, the largest insurance losses:



* Estimate

Source: Insurance Information Institute

Christopher Oster, "Can the Risk of Terrorism Be Calculated By Insurers?" *Wall Street Journal*, April 8, 2002, Page C1.

Principal Mutual Life

The Federal Circuit ruled in *Principal Mutual Life*[41] that an insurance company must include excess interest guaranteed beyond the end of the tax year in its statutory reserves.

Principal had maintained several accounts in which the guaranteed interest rates exceeded the prevailing state assumed rate. The interest reserves for those accounts consisted of the present value of the excess interest guaranteed on the accounts for the rest of the guarantee periods. The issue in the case was the classification of these reserves in calculating statutory and tax reserves under Section 809(b)(4).

In the Court of Federal Claims, Principal took the position that the then-applicable version of Section 811(d) required it to exclude excess interest reserves from both statutory and tax reserves when calculating the company's average equity base under Section 809(b)(4).

The Federal Circuit, like the trial court, reasoned that the term "computing" in Section 811(d) most naturally referred only to tax reserves, since statutory reserves are not "computed," but are taken directly from the reserves in the annual statement. The Federal Circuit further concluded that the context of the Code provided substantial support for the government's position, as did the legislative history.

Composite Discount Factors

Revenue Procedure 2002-74[42]

The IRS announced that for purposes of loss reserve and salvage discounting, it will issue composite discount factors for accident years not generally disclosed on the annual statement. These factors supersede the composite factor methodology detailed in Notice 88-100 for taxpayers not using their historical payment pattern. Taxpayers electing to calculate discount factors based on their historical payment pattern should continue to apply the

[41] *Principal Mut. Life Ins. Co. v. United States*, 295 F.3d 1241 (Fed. Cir. 2002).

[42] Rev. Proc. 2002-74, 2002-51 I.R.B. 980.

Notice 88-100 methodology using their historical data to compute composite discount factors. Many taxpayers have found significant time-value tax benefits from the application of Notice 88-100.

Taxpayers who wish to change their method of discounting reserves from the composite factor discounting method to the separate discounting of all accident years or vice versa, will be subject to the change in accounting method provisions of Sections 446 and 481.

Rev. Proc. 2002-74 was issued in response to recent requests for rulings on accounting method changes related to the change from composite discounting to separately stating and discounting all accident years for individual lines of business. The provisions of Rev. Proc. 2002-74 generally are effective for tax years ending on or after December 4, 2002.

> ***It appears that the reinsurance industry is having to return to old-fashioned underwriting to make its money, rather than relying on investments or releases from reserves. "What we're seeing in the market is a return to underwriting discipline. Certainly, among our competitors in the reinsurance field, we see a realization that we need to go back to what we do best, which is our core competency – underwriting."***
>
> Patrick Mailloux, President and CEO, Swiss Re America, *National Underwriter*, July 15, 2002, Page S-4.

Equitable Life Assurance

In Equitable Life Assurance v. United States,[43] the U.S. District Court held that the tax benefit rule does not serve to exclude from income certain decreases in life insurance reserves that are otherwise required to be included as income.

Equitable is a mutual life insurance company. The company filed a claim for refund of $76,902,609 in taxes, asserting that it was taxed improperly for certain "releases" of life insurance reserves in 1982.

[43] *Equitable Life Assurance Society of the United States v. United States*, S.C. N.Y., No. 00 Civ. 4066 (RMB), 2/6/02.

From 1958 to 1981, Equitable was taxed only on its Phase I, or investment income, not its Phase II underwriting income. Beginning in 1982, Equitable was characterized as a Phase II company. Equitable argued that the 1982 reserve releases on which it was taxed were created from 1959 to 1981. Because reserve increases only reduced Phase II income, and because Equitable did not pay tax based upon its Phase II income from 1958 to 1981, any deductions Equitable may have taken for adding to its reserves in those years provided no tax benefit.

The Court rejected Equitable's argument. In its decision, the Court followed the reasoning of the Federal Circuit Court in *American Mutual Life Insurance Co. v. United States*. The analysis involved three principles.

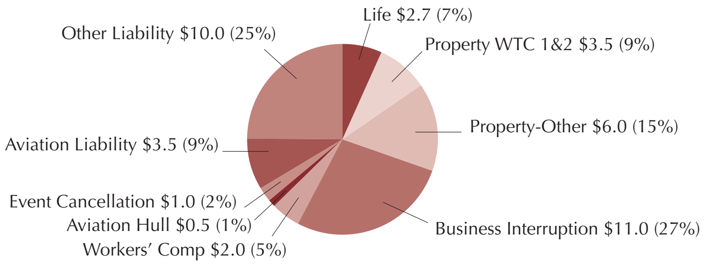
First, where there is tension between the tax benefit rule and other provisions of the Code, attention should be directed to the provisions that govern the transactions to determine if they prevail over the principle of the tax benefit rule. The Court found that the Code mandates taking the reserve releases into taxable income.

Second, to invoke the tax benefit rule, a reserve does not always have to be a recovery of an "amount deducted in any prior taxable year"; however, the tax benefit rule should be applied on a case-by-case basis. Equitable argued the reserve releases constitute a recoverable. The Court disagreed: "Here, nothing is paid to the taxpayer when reserves are released. The taxpayer merely has an accounting or 'book' change reflecting the reversal of a previous potential, estimated liability. In most cases, this discharge is accompanied by a payment of the exact liability - a reduction in assets."

Third, the "recovery" must be "fundamentally inconsistent with the premise upon which the deduction was originally based." That is, if the event had occurred within the same taxable year, it would have foreclosed the deduction. The Court concluded, "If there is anything that is consistent and foreseen, it is that life insurance reserves will be released… We agree with the Court of Federal Claims that the life insurance reserve releases were not a fundamentally inconsistent occurrence."

In the American Mutual decision, the Court of Federal Claims noted that had there been no change in taxable income resulting from the reserve deductions, the argument would have merit. The District Court in this case summarily denied that the tax benefit rule can be applied to the release of life insurance reserves.

SEPTEMBER 11 INDUSTRY LOSS ESTIMATES *(in billions)*



Robert P. Hartwig, "Terrorism Leaves WC Insurers Exposed," *National Underwriter*, August 19, 2002, Page 16.

Guideline XXXIII

Revenue Ruling 2002-6

The IRS issued Revenue Ruling 2002-6[44] which takes the position that a change in the computation of existing life insurance reserves to take into account specific factors set forth in Actuarial Guideline XXXIII (AG 33) is a change in basis subject to Section 807(f).

The NAIC adopted AG 33, Commissioners Annuities Reserve Valuation Method (CARVM), effective on December 31, 1995. In computing its end of the year life insurance reserves under Section 807(d)(2), the taxpayer did not take into account several specific factors set forth by the NAIC in AG 33. In 2001, the taxpayer modified its reserve computation to take those factors into account in computing its end of year 2001 reserves for annuity contracts.

44 Rev. Rul. 2002-6, 2002-6 I.R.B. 460.

The IRS recognized that AG 33 contains the statement that the guideline "does not constitute a change of method or basis from any previously used method," and that this statement could incorrectly imply that taking the guideline into account in a company's CARVM computation would not result in a change in basis. However, the IRS noted that for a life insurance company, any change in a company's tax reserve method is a change in basis subject to the change in basis rules under Section 807(f). The IRS also continued to hold steadfast to its contention that all changes except a computational mistake would result in a basis change subject to a 10-year spread.

Proposed Regulations – Modified Guaranteed Contracts

The IRS issued proposed regulations under Sections 807, 811, 812, and 817A.[45] The proposed regulations define the appropriate interest rate to be used in the determination of tax reserves and required interest for certain modified guaranteed contracts. The proposed regulations also address how temporary guarantee periods that extend past the end of a taxable year are to be taken into account.

Shortly after issuing the proposed regulations, the IRS issued corrections to the regulations.[46] The corrections were issued to clarify the definition of a temporary guaranteed rate and did not affect the substance of the regulations. The correction made it clear that the temporary guaranteed rate "may be a rate based on stocks, other equity instruments, or equity-based derivatives (equity-indexed modified guaranteed contracts) or a rate that is not related to equity performance (non-equity-indexed modified guaranteed contracts)."

[45] 67 Fed. Reg. 38214 (June 3, 2002).

[46] 67 Fed. Reg. 41653 (June 19, 2002).

Chapter 4

Captives

As insurance costs skyrocketed following September 11th, ushering in a new "hard" market, companies began turning in larger numbers to captive insurance arrangements as a way to lower insurance costs, and in some cases, as the only way to obtain necessary coverage.

Despite the 2001 announcement that it would abandon the economic family theory,[47] during 2002, the IRS continued to investigate captive arrangements and challenge them on their substance where they believed it to be weak. The IRS issued a Notice making certain producer-owned reinsurance companies listed transactions and released a Field Service Advice[48] questioning the legality of a captive arrangement. Additionally, the IRS released three Revenue Rulings relating to captive insurance arrangements and a Revenue Procedure announcing it will consider ruling requests related to captive insurance arrangements.

The nation's airlines are moving closer to finalizing a plan to form their own insurance company, an undertaking that has gained the tentative support of the Transportation Department. Airline executives met Thursday in Washington to discuss a proposed airline-owned insurance company that would provide them with coverage for acts of war and terrorism, instead of going back to the commercial market.

Christopher Oster and Stephen Power, "U.S. Airlines Move to Form Company for Self-Insurance," *Wall Street Journal*, March 4, 2002, Page B2.

[47] Rev. Rul. 2001-31, 2001-26 I.R.B.1346.

[48] 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.

Producer-Owned Reinsurance Companies (PORCs)

Notice 2002-70[49] identified as a listed tax shelter transaction certain arrangements used by taxpayers to shift income to related companies purported to be insurance companies that are subject to little or no U.S. federal income tax.

The transaction described in Notice 2002-70 involves a Taxpayer that offers customers the opportunity to purchase an insurance contract in connection with products or services being sold. The taxpayer offers the insurance to customers by acting as an agent for an unrelated insurance company and receives a sales commission from the insurance company. The taxpayer then forms a PORC as a wholly-owned corporation, typically in a foreign country, to reinsure the policies. The PORC then elects to be treated as a domestic insurance company under Section 953(d), and takes the position that it is entitled to the benefits of Sections 501(c)(15), 806, or 831.

The IRS stated that many of the transactions described in the Notice have been designed to use a reinsurance arrangement to divert income to taxpayers' wholly owned insurance companies, that are subject to little or no federal income tax. The IRS stated that it would challenge the transactions on a number of grounds.

Transactions that are the same as, or substantially similar to, the transaction described in Notice 2002-70 are "listed transactions" for purposes of Treas. Reg. 1.6011-4T(b)(2) and 301.6111-2T(b)(2). Tax shelter disclosure and registration requirements also apply. The impact of this ruling will affect not only the Taxpayer's captive, but also those parties involved in structuring, opining on, and facilitating the captive arrangement.

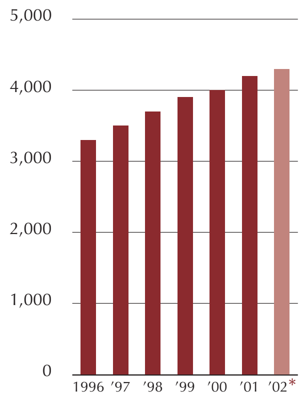
[49] Notice 2002-70, 2002-44 I.R.B. 765.

Captive Rulings

These rulings addressed whether amounts paid by a domestic parent corporation to its wholly owned insurance subsidiary were deductible as "insurance premiums" under Section 162. The rulings provided continued support for the deductibility of premium payments and insurance reserves in captive situations where there is adequate capitalization, arms-length pricing, and requisite risk shifting and risk distribution.

MOVING IN-HOUSE

Number of captive-insurance companies



Source: A.M. Best

* Through June 30

Christopher Oster, "As Premiums Soar, Some Big Firms Do Without or Set Up Their Own; Profits Might Benefit – For Now," *Wall Street Journal*, August 1, 2002, Page C1.

Revenue Ruling 2002-89[50]

This ruling describes a situation in which P enters into an annual arrangement with S, its wholly owned subsidiary, whereby S "insures" the risks of P. The premiums S earns from P constitute 90% of S's total premiums earned during the year, while the balance of the premiums are earned from completely unrelated parties. The IRS ruled that the arrangement between P and S lacked

[50] Rev. Rul. 2002-89, 2002-52 I.R.B. 984.

the requisite risk shifting and risk distribution to constitute insurance, and that amounts paid by P to S were not deductible as "insurance premiums."

In a second situation, the premiums S earned from the arrangement with P constituted less than 50% of S's total premiums during the tax year, while the balance of the premiums were earned from completely unrelated parties. Here, the IRS found that the requisite risk shifting and risk distribution were present, and that the amounts paid by P to S were deductible as "insurance premiums."

Revenue Ruling 2002-90[51]

In this ruling, P formed S as a wholly-owned insurance subsidiary. S directly insured the professional liability risks of the operating subsidiaries in the P group and charged arms'-length premiums. None of the operating subsidiaries had liability coverage for less than 5 percent or more than 15 percent of the total risk insured by S. S retained the risks that it insured and only provided coverage to the 12 operating subsidiaries.

The IRS concluded that the arrangements between S and the operating subsidiaries constituted insurance for federal income tax purposes, and the amounts paid for professional liability coverage to S were deductible "insurance premiums."

Revenue Ruling 2002-91[52]

The IRS ruled on whether a "group captive" was an insurance company under Section 831. X and a significant number of businesses in the industry formed a "group captive" to provide insurance coverage for stated liability risks. No single member owned more than 15 percent of the captive, held more than 15 percent of the vote on any corporate governance issue, or received coverage exceeding 15 percent of the total risk insured by the captive.

The IRS held that the contracts issued by the group captive to X and the other members were insurance contracts, and the premiums paid by the

[51] Rev. Rul. 2002-90, 2002-52 I.R.B. 985.

[52] Rev. Rul. 2002-91, 2002-52 I.R.B. 991.

members were deductible, and the group captive would be treated as an insurance company under Section 831.

While these rulings are helpful in providing structure guidelines for these transactions, they provide no real new information and have raised new questions. Taxpayers have already questioned whether the 15% allocated risk or the 12 companies sets the standard. Moreover, there remains a question whether the captive insurance structure in Revenue Ruling 2002-89 situation two would be respected if the non-P premiums were attributable to risks of brother-sister affiliates rather than completely unrelated risks.

> ***Post-Enron concerns over off-balance-sheet accounting mean that risk managers will have a lot more explaining to do to justify the use of off-shore captives to their nervous CFOs. Indeed, because of the Enron situation, senior management is asking a lot more questions about captives. As a result [managers] have to bring company management up to speed about what an insurance subsidiary can do and what it means.***
>
> Lisa S. Howard, "Enron Spurs Concerns about Captives," National Underwriter, April 29, 2002, Page 11.

Ruling Requests

Revenue Procedure 2002-75[53]

The IRS issued Rev. Proc. 2002-75, announcing it will consider ruling requests related to captive insurance arrangements. Previously, the IRS would not consider ruling requests as to whether risk shifting and risk distribution were present with respect to the qualification of a company as an insurance company or to the deductibility of taxpayer "insurance" premium payments.

Discussions with Treasury indicated that the IRS is well aware of the intricate nature of captive insurance arrangements, and that this guidance has been issued in the hopes that taxpayers engage in discussions with and request rulings from the IRS with respect to captive insurance arrangements.

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

> ***Pricing has increasingly become an attention-getter. Horror stories of price increases are abundant throughout the industry, and captives are no exception. We are aware of captives being asked to pay increases of 500 percent in some excess coverages, such as workers' compensation. This increased unavailability and cost of reinsurance has caused captives to play a greater role than originally intended in accepting risk for their parent companies. Even so, captives are the flavor of the year. A company with financial resources and organizational ability has no real reason not to proceed.***
>
> Michael R. Mead, "Captives Endure Market Challenges," *National Underwriter*, March 4, 2002, Page 14.

Questionable Captive Arrangement

FSA 200202002

The IRS released FSA 200202002,[54] which cast substantial doubt over the legality of a captive insurance arrangement, but also determined that additional development was warranted before conclusions concerning deductions could be reached.

During the years under consideration in the FSA, Grandparent was the parent of all of the related companies discussed. Insurance Subsidiary was a Country R corporation and was incorporated to provide environmental liability coverage to Grandparent's U.S. operating subsidiaries. The IRS found fault with deductions related to Insurance Subsidiary premiums paid. The IRS determined that the transactions at issue lacked sufficient risk distribution to constitute insurance, because one insured accounted for 86 to 88 percent of Insurance Subsidiary's premium income.

Additionally, the IRS questioned whether there was adequate risk shifting and cited an excessive degree of informality between the parties.

[54] FSA 200202002 (September 28, 2001).

Chapter 5

Tax Shelters

No area received as much attention from the IRS and the press during 2002 as tax shelters. While not a new topic, the non-stop press coverage on tax motivated transactions ranging from Enron's off-shore transactions to WalMart's lawsuit against its COLI broker and underwriter fanned the flames. The so-called tax shelters were discussed, debated, and vilified again and again in the news as well as in the chambers of Congress.

In a continued quest to gain information on tax shelters, the IRS announced procedures regarding requests for tax accrual work papers and settlements of existing tax shelter transactions, and promulgated new tax shelter regulations, money laundering regulations, and inversion reporting regulations.

The IRS also widened its net to include producer-owned reinsurance companies (PORCs), making them "listed transactions" for purposes of Treas. Reg. 1.6011-4T(b)(2) and 301.6111-2T(b)(2). Surprisingly, the IRS confirmed that the existence of a tax exempt determination letter would be of no consequence in determining the applicability of the notice to a PORC and confirmed that the description of the transaction was generic and would pick up all PORCs regardless of whether they had abusive facts.

Tax Shelter Regulations

Section 6011 Regulations

In October 2002, the IRS issued[55] revised temporary and proposed tax shelter regulations to replace the temporary and proposed regulations issued in June 2002. The regulations address "tax shelter" disclosure statements and the requirement to maintain a list of investors in potentially abusive tax shelters by "material advisors." The revised temporary regulations generally will apply with respect to transactions entered into after December 31, 2002.

The regulations replace the former regime for identifying reportable transactions with a list of six specific categories. If a transaction fits within any one of these categories, it is a reportable transaction, disclosure is required, and promoters must maintain investor lists for such transactions.

The six categories are:

- Listed transactions (i.e., transactions that are the same as or substantially similar to those that have been specifically identified by the IRS as tax avoidance transactions);
- Transactions marketed under conditions of confidentiality;
- Transactions with contractual protection;
- Transactions generating a tax loss under Section 165 exceeding specified amounts;
- Transactions resulting in a book-tax difference exceeding $10 million on a gross basis; and
- Transactions generating a tax credit when the underlying asset is held for a brief period of time.

The six categories contain clarifications, exceptions, and exclusions (i.e., Section 165 losses from fire, storm, shipwreck, or other casualty, or from theft are excluded). However, it is important to note that because normal business practice frequently causes book-tax differences to arise, the regulations can have an impact on taxpayers who do not knowingly engage in a tax shelter transaction.

[55] 67 Fed. Reg. 64799 (October 22, 2002).

> ***The Treasury Department and the Internal Revenue Service, facing congressional pressure to curb a proliferation of sophisticated tax shelters, announced a long list of changes they intend to make to tighten porous rules. Above all, Treasury wants to strengthen existing rules that require taxpayers and tax-shelter promoters to tell the IRS about their use of shelters. Current disclosure rules have been in effect for about two years, but results have been disappointing. As of last year, only about 300 shelters had been disclosed by corporations, though promoters had registered more than 3,000 with the IRS.***
>
> John D. McKinnon, "Under Pressure, Treasury and IRS Attack Shelters"
> *Wall Street Journal*, March 21, 2002, Page A2.

Temporary and Proposed Section 6043(c) Regulations

The IRS issued[56] temporary and proposed regulations requiring information reporting by a corporation if control of the corporation is acquired or if the corporation has a recapitalization or other substantial change in capital structure, and the shareholders receive stock, cash or property worth $100 million or more. The temporary regulations require the acquired corporation (or its successor) to attach Form 8806 to its income tax return describing the transaction, and to file information returns with respect to certain shareholders in such transactions (information returns are not required with respect to most tax-exempt shareholders).

The regulations define an acquisition of control and substantial change in capital structure and require a domestic corporation involved in the specified transactions to issue to shareholders a Form 1099-CAP. The Form reports the amount of any cash plus the fair market value of any property provided to the shareholder in the transaction, if the shareholder is expected to recognize gain.

Proposed regulations under Section 6043(c) were previously published in 1990. After considering public comments and the reporting burdens placed on taxpayers, the IRS withdrew the regulations in 1992; however, the IRS stated that it would promulgate regulations under Section 6043(c) if it

[56] 67 Fed. Reg. 69468 (Nov. 18, 2002).

became apparent that the information would be needed to administer the tax system properly. Following September 11th and the inversion (or proposed inversions) of several high-profile U.S. companies, the media and certain members of Congress questioned the motivation of these transactions. The Section 6043 regulations appeared to be the IRS's first response.

Tax Shelter Settlement Programs

Announcement 2002-96, Announcement 2002-97, and Revenue Procedure 2002-67

In an aggressive move to deal with tax shelter issues, the IRS announced that taxpayers involved in certain types of tax shelters would have limited time to accept IRS offers to resolve their tax issues. After the settlement periods end, the IRS will pursue the remaining cases through its usual enforcement processes, including litigation.

The settlement offers require taxpayers to pay significant amounts of tax, plus interest; however, the specific settlements depend on the merits of each transaction and each case. The IRS will also consider whether penalties should apply where taxpayers did not previously disclose their abusive transactions.

In Announcement 2002-97[57] and Revenue Procedure 2002-67,[58] respectively, the IRS issued settlement procedures with respect to two transactions that became listed tax shelter transactions in 2001(Section 302/318 basis shifting transactions and Section 351 "Contingent Liability Transactions"). The IRS had not previously offered any settlements related to these transactions. Taxpayers in the basis shifting transaction had until December 3, 2002, to notify the IRS of their decision to participate in this settlement initiative. Those in the contingent liability transaction had until January 2, 2003, to apply for resolution of their tax liability under one of two settlement processes.

The IRS announced that it was discontinuing its settlement program for certain corporate-owned life insurance (COLI) in Announcement 2002-96.[59] Taxpayers received letters giving them 45 days to accept the offer before it ended.

[57] Announcement 2002-97, 2002-43 I.R.B. 757.

[58] Rev. Proc. 2002-67, 2002-43 I.R.B. 733.

[59] Announcement 2002-96, 2002-43 I.R.B. 756.

> *"This effort is a way to resolve cases without months or years of costly litigation while making it clear to taxpayers who may consider participating in abusive tax shelters in the future that they will end up in a bad deal," said IRS Commissioner Charles O. Rossotti.*
>
> IR 2002-105 (4 Oct. 2002).

Tax Accrual Work Papers

The IRS issued Announcement 2002-63 regarding requests for tax accrual workpapers. The Announcement is a "living document" that the IRS intends to revise as issues are raised. Two drafts were issued during 2002.

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

For returns filed on or after July 1, 2002, that claim a tax benefit from a listed transaction, the following procedures apply:

- **(a)** If the transaction was disclosed in accordance with Treas. Reg. 1.6011-4T, the IRS will request the work papers pertaining only to the listed transaction.
- **(b)** If the transaction was not disclosed in accordance with Treas. Reg. 1.6011-4T, the IRS will routinely request all tax accrual workpapers.
- **(c)** If tax benefits from multiple investments in listed transactions are claimed, regardless of whether the transactions were disclosed, the IRS will request all tax accrual workpapers.
- **(d)** If benefits from a listed transaction are claimed on a tax return that was disclosed, but there are reported financial accounting irregularities, the IRS will request all tax accrual workpapers.

For returns filed prior to July 1, 2002, the IRS will request tax accrual workpapers pertaining to a listed transaction if the taxpayer had an obligation to disclose the transaction and failed to do so. The request will be limited to workpapers pertaining to the listed transaction.

Tax practitioners and corporations expressed concern that because there is no clear definition of what is "substantially similar," revenue agents will interpret the standard too broadly and attempt to request all tax accrual workpapers. In response, the IRS stated that its intent is to apply the policy in a limited way.

David R. Hardy of McDermott, Will & Emery, New York, submitted comments on the proposed regulations regarding the required reporting of tax shelter transactions. Hardy asserted that it is inappropriate for the proposed regs to treat the mere existence of tax result insurance as a sufficient basis to require tax shelter disclosure. He recommended excepting tax result insurance from the coverage of the proposed regs.

David R. Hardy, "Attorney Seeks Tax Result Insurance Exception to Proposed Tax Shelter Reporting Regs," *Tax Notes Today*, January 7, 2003, 2003 TNT 3-63.

USA Patriot Act

The IRS issued[60] proposed rules affecting the life insurance industry under the USA Patriot Act.[61] The proposed rules required insurance companies to establish an anti-money laundering program, as specified under Section 352 of the Act.

Under the proposed rules, a company must establish and maintain a written anti-money laundering program that, at a minimum: **(1)** incorporates internal policies, procedures, and controls; **(2)** designates a compliance officer; **(3)** establishes an ongoing employee training program; and **(4)** establishes an independent audit function to test programs.

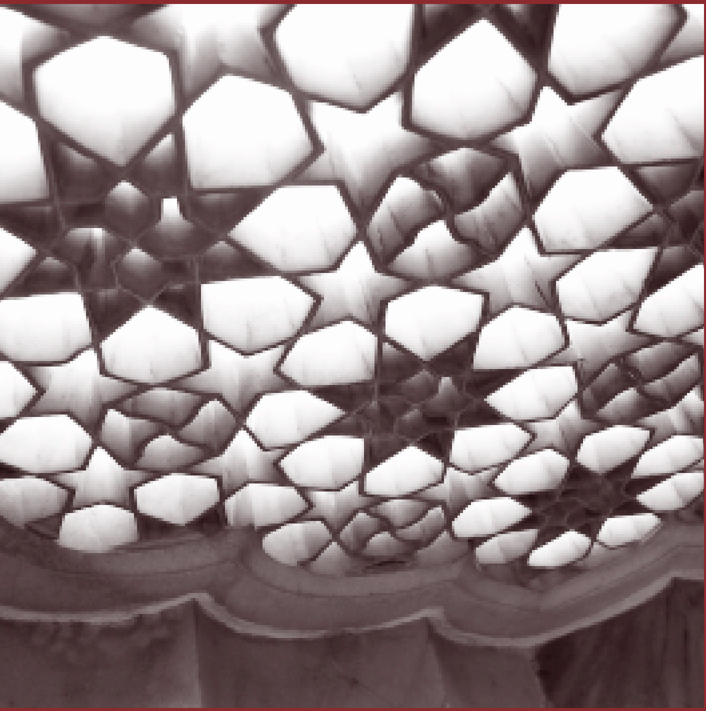
[60] 31 CFR 103.175-103.178.

[61] The "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001," P.L. 107-56.

> ***Broker/dealers should evaluate at least seven "risk factors" in determining how to set up the customer identification program mandated by the USA Patriot Act, according to a proposed rule released by the Treasury Department. The Act requires financial institutions to implement "reasonable procedures" to identify customers and determine whether they might appear on lists of known or suspected terrorists.***
>
> Steven Brostoff, "Treasury Issues Proposed Rule for B/Ds On Consumer Identification," *National Underwriter*, July 22, 2002, Page 34.

The proposed rules outlined the money laundering and terrorist financing risks associated with insurance companies. The proposed rules did not apply to property and casualty companies. The P&C industry had asked to be excepted from the rules because it does not lend itself to money laundering.

Chapter 6



Reorganizations

Some of the industry's most important developments during 2002 occurred in the area of reorganizations. The IRS released several anticipated documents, including the proposed regulations under Section 338(h)(10), relating to the deemed sale or acquisition of an insurance company's assets. The 338(h)(10) regulations were controversial in instructing taxpayers to treat deemed asset acquisitions as assumption reinsurance for tax purposes. Several comment letters were submitted by the insurance industry.

Other industry developments relating to reorganizations included the issuance of Revenue Procedure 2002-32, waiving restrictions on reconsolidation; a District Court judgment in favor of GE Life and Annuity Assurance Company[62] on the exclusion of the policyholder surplus account in taxable income in a Section 338 transaction; a Federal Claims Court ruling against Globe Life[63] disallowing deductions for amortization of "agency-force"; several private letter rulings treating demutualization transactions as Section 368(a)(1)(E) reorganizations; and a field service advice release, dealing with a retroactive stock basis increase to account for a company's "fresh start" adjustment.

[62] *GE Life and Annuity Assurance Co. v. United States*, 89 A.F.T.R.2d 2002-1815 (E.D.Va. Mar 25, 2002).

[63] *Globe Life and Acc. Ins. Co. v. United States*, 54 Fed.Cl. 132 (2002).

In the markets, several prominent companies divested some or all of their insurance operations. Citigroup Inc. completed its spin-off of Travelers in April. GE acknowledged plans to spin off Employers Reinsurance, a move it had been considering prior to September 11th.[64] In July, however, the conglomerate retracted its IPO plans, citing weakness in the overall market,[65] but continued searching for a buyer. In October, Prudential Financial Inc. said it was exploring the possibility of selling its personal auto-insurance and home-insurance operations.[66] At the close of the year, others speculated that Credit Suisse First Boston could split with the group's financial-services division, which includes private banking and insurance.[67]

Section 338(h)(10) Regulations

The IRS published final regulations under Section 338 in 2001. At that time, and in response to numerous questions and requests for clarification, the IRS announced its intention to provide guidance regarding the treatment of a deemed asset sale by an insurance company. In March 2002, the IRS released[68] such guidance in the form of proposed regulations applicable to **(1)** the deemed sale or acquisition of an insurance company's assets under Section 338, **(2)** the sale of an insurance trade or business under Section 1060, and **(3)** the sale of insurance contracts through assumption reinsurance. The proposed regulations are comprehensive, provide a number of helpful examples, and respond directly to taxpayers' requests for details.

The proposed regulations reflect the IRS' position that the proper model to be utilized in the acquisition of an insurance business is that of an assumption reinsurance transaction. The regulations address, and remove, the "immediate income" problem that can occur in some situations. Further, the proposed regulations also address other issues under Sections 197, 381, 846, 847, and 1060 that arise in the context of deemed asset sales and assumption reinsurance transactions.

64 "Equity Analysts: Hard Market Spurs Property/Casualty Spinoffs," AM Best News Service, March 21, 2002.

65 "GE Postpones Plan to Split off its Employers Reinsurance Unit," *Wall Street Journal*, July 12, 2002, Page A2.

66 "Prudential Financial Inc.: Sale of Insurance Operation Is Among Possibilities for Unit," *Wall Street Journal*, October 4, 2002, page B8.

67 Marcus Walker and Erik Portanger, "Credit Suisse Shuffle: Co-Heads are Named, So Will CSFB Split?" *Wall Street Journal*, September 20, 2002, page C1.

68 67 F.R. 10640 (March 8, 2002).

Key elements of the proposed regulations include:

(1) In general, the seller's tax reserves would be treated in the same manner as fixed liabilities that have been taken into account for Federal income tax purposes and, thus, the seller's closing tax reserves would be treated as a liability in the computation of the seller's aggregate deemed sales price (ADSP) and the buyer's adjusted grossed-up basis (AGUB).

(2) The residual method that otherwise applies to transactions governed by Sections 338 and 1060 would apply to allocate the ADSP and AGUB among classes of transferred assets, including insurance contracts, which constitute Class VI assets (regardless of whether they are Section 197 intangibles).

(3) The gross amount (before any ceding commission) of the reinsurance premium paid by the seller to the buyer would be deemed to equal the seller's closing tax reserves in all cases, thereby eliminating the possibility of immediate net taxable income to the buyer.

THE TOP TEN INSURANCE-RELATED MERGERS AND ACQUISITIONS REPORTED IN 2001* *($ millions)*

SELLER	BUYER	TRANSACTION VALUE
American General Corp	American International Group, Inc.	$23,200
Chiyoda Mutual Life Insurance Co.	American International Group, Inc.	2,760
Lincoln Re	Swiss Reinsurance Co.	2,000
Keyport Life Insurance Co. and Independent Financial Marketing Group	Sun Life Financial Services of Canada, Inc.	1,700
Provident Mutual Life Insurance Co.	Nationwide Financial Services, Inc.	1,560
RightCHOICE Managed Care, Inc.	Wellpoint Health Networks, Inc.	1,300
Care First Blue Cross Blue Shield	Wellpoint Health Networks, Inc.	1,300
J.C. Penney Direct Marketing Services, Inc.	Aegon NV	1,300
Fortis Financial Group	Hartford Financial Services Group, Inc.	1,120
National Mutual Life Assurance Society	GE Capital Corp.	803
TOTAL		**$37,043**

* At least one of the companies involved in the transaction is a U.S.-domiciled insurer. Includes property/casualty, life, health/managed care, service and distribution companies.

Source: Conning & Company, 2002.

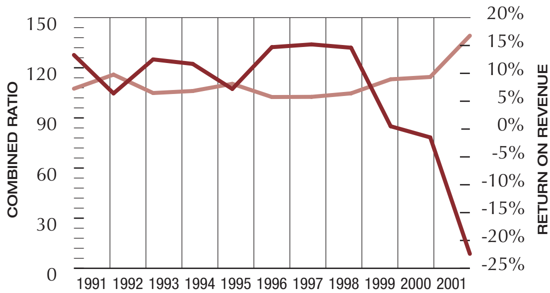
Insurance Information Institute, *The Financial Services Fact Book 2003*, Page 22

Rules governing the computation and allocation of AGUB and ADSP apply to applicable asset acquisitions. To insure that these rules apply only to acquisitions of insurance businesses and not to ordinary reinsurance transactions, the proposed rules indicate that the mere reinsurance of insurance contracts by an insurance company is not an applicable asset acquisition. However, the transfer of an insurance business is an applicable asset acquisition if the purchaser acquires significant business assets to which goodwill and going concern value could attach.

The preamble states that while Treas. Reg. 1.817-4(d) prescribes rules for the income tax treatment of assumption reinsurance transactions entered into by life insurance companies in the ordinary course of business, the general structure of the regulations is not based on any statutory provisions unique to life insurance companies, justifying their application to property/casualty transactions. Moreover, because these rules are an application of general principles of insurance taxation, many should apply *not only* to assumption reinsurance transactions, *but also* to indemnity reinsurance transactions.

The proposed regulations would treat the consideration allocated to the value of the insurance contracts acquired in the assumption reinsurance transaction as an amount paid by the reinsurer to purchase intangible assets, and as ordinary income to the ceding company. For purposes of computing ADSP and AGUB, the proposed regulations treat old target's closing **tax** reserves as a liability. Although the IRS states that it would be inappropriate to require capitalization of all post-acquisition increases in an insurance company's assumed reserve liabilities, certain post-acquisition reserve increases are to be capitalized where the ceding company's tax reserves as of the acquisition date are understated. Tax reserve increases from three sources with respect to acquired contracts could potentially be subject to capitalization under these proposed regulations: **(1)** increases of unpaid loss reserves attributable to changes in loss estimates, **(2)** increases of other reserves through changes in methodology or assumptions, and **(3)** increases of unpaid loss reserves as a result of reinsuring acquired contracts at a loss. In particular, the proposed regulations require capitalization of unpaid loss reserve increases in excess of cumulative annual increases of two percent from the acquisition date and reserves for unpaid losses attributable to acquired insurance contracts.

THE S&P TOP 50 U.S. PROPERTY & CASUALTY REINSURERS
COMBINED RATIO VS. RETURN ON REVENUE 1991-2001



	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
CR	107.5	115.9	104.9	106.1	110.4	102.5	102.6	104.7	113.1	114.5	139.2
ROR	13.3%	6.4%	12.5%	11.7%	7.2%	14.7%	15.2%	14.6%	0.5%	-1.5%	-22.4%

Combined Ratio — Return on Revenue

The combined ratio and return on revenue of the S&P Top 50 U.S. Property and Casualty Reinsurers correspond to the list published in that year.

Source: Standard & Poor's Insurance Ratings

Lisa S. Howard, "U.S. Reinsurers Look to Make Money the Old-Fashioned Way: By Underwriting," *National Underwriter*, July 15, 2002, Page S

To the extent a reinsurer is required to capitalize reserve increases, the reinsurer must include the amount in gross income to offset Section 832(b)(5) deductions for the reserve increases. The reinsurer must include the amount to be capitalized in AGUB and treat such amount as additional premium received in the deemed asset sale as of the year of the adjustment. The ceding company does not make any adjustments under this provision.

> ***Favorable market conditions and convergence factors unique to the property/casualty segment have encouraged financial-services giant Citigroup Inc. to spin off its property/casualty subsidiary, followed by speculation that General Electric Co. is considering doing the same with its reinsurance unit.***
>
> "Equity Analysts: Hard Market Spurs Property/Casualty Spinoffs" *AM Best News Service*, March 21, 2002.

SECTION 197

The regulations propose amendments to the regulations under Section 197 to provide guidance concerning the treatment of insurance contracts acquired through assumption reinsurance transactions. The proposed regulations clarify that Section 197(f)(5) determines the basis of an amortizable Section 197 asset with respect to insurance contracts acquired in an assumption reinsurance transaction.

The amount paid or incurred by the reinsurer in the assumption reinsurance transaction over the amount required to be capitalized under Section 848 in connection with the transaction is treated as a Section 197 intangible for which an amortization deduction is allowed under Section 197(a). The regulations define the amount paid or incurred by the reinsurer for the insurance contracts (which is the amount of the AGUB or consideration allocable to the insurance contracts under the residual method) and the amount required to be capitalized under Section 848 in connection with the transaction.

The amount required to be capitalized under Section 848 in connection with the acquisition of the relevant contracts is determined at the end of the year by multiplying the DAC for the taxable year by a fraction, the numerator of which is the tentative positive capitalization amount for the group of acquired insurance contracts and the denominator of which is the total tentative positive capitalization amount for the taxable year with regard to all specified insurance contracts.

Finally, the proposed regulations provide guidance for a disposition of a Section 197(f)(5) intangible. The proposed regulations provide specific guidance regarding when recovery of basis is allowed in the context of an indemnity reinsurance transaction. The transfer through indemnity reinsurance of the right to the future income from the insurance contracts to which a Section 197(f)(5) intangible relates does not necessarily preclude the recovery of basis by the ceding company, provided that sufficient economic rights relating to the reinsured contracts are transferred to the reinsurer.

Likewise, the proposed regulations clarify when a loss **can** be recognized on the disposition of a Section 197 intangible. The loss recognized on the disposition of a Section 197(f)(5) intangible equals the amount by which the taxpayer's adjusted basis in the intangible prior to the disposition exceeds the amount that the taxpayer receives for the future income right from the insurance contracts. In determining the amount of the taxpayer's loss on the disposition of the intangible through a reinsurance transaction, any effect of the transaction on the amounts capitalized by the taxpayer as DAC is disregarded.

The application of these rules, among others, are detailed in a number of examples. For companies with significant negative consideration during the course of the year, the basis calculation has the effect of allocating more basis away from a 10-year Section 848 amortization to a 15-year Section 197 amortization.

SECTION 381

DAC (Section 848) amounts are intended to serve as a proxy for an insurance company's actual cost of acquiring insurance contracts. The proposed regulations state that once the ceding company no longer conducts an insurance business, any relief from capitalization it might have enjoyed going forward is not appropriately transferred to a taxpayer other than a successor insurance company under Section 381. The proposed regulations clarify that remaining balances of DAC or excess negative DAC will carry over to a successor insurance company in a Section 381 transaction. In all other cases, if, after giving effect to the reinsurance transaction in the deemed asset sale, the ceding company has remaining DAC or excess negative DAC, that remaining DAC is expensed or excess negative DAC is eliminated.

Any boot distributed to a person other than the acquiring corporation will be treated as a distribution under Section 815. However, notwithstanding the boot distribution rule, if the transferor corporation transfers less than 50 percent of its insurance business to the acquiring corporation, the acquiring corporation will succeed to a ratable portion of the dollar balances in the transferor's policyholders surplus account. The percentage of such accounts to which the acquiring corporation succeeds is determined by the ratio of the transferor's insurance reserves for the contracts transferred under Section 816(b), to the transferor's reserves for all of its contracts under Section 816(b).

Some courts have divided over whether the deemed asset sale resulting from a Section 338(g) election gives rise to a distribution by the acquired corporation of the PSA to its shareholders. (*See, e.g., the GE Life* case discussed above.) The proposed regulations effectively provide that the deemed asset sale pursuant to a Section 338(g) election effects a distribution of the acquired corporation's PSA to the selling shareholders to the extent the grossed-up amount realized exceeds the shareholders surplus account.

SECTION 847

To the extent that old target is deemed to transfer its insurance business to new target, old target's special loss discount account under Section 847 must be reduced to the extent attributable to the transferred insurance business, and old target must include the amount of the reduction in gross income. However, if any of old target's insurance business is distributed to its shareholders in a Section 381 transaction, the acquiring corporation succeeds to the portion of old target's special loss discount account that is attributable to the insurance business that is transferred. Old target may apply the balance of its special estimated tax account as a credit against any tax resulting from the inclusion of this income. Any special estimated tax payments remaining after the credit are voided.

SECTION 846

Under Section 846(e), an insurance company may elect to compute discounted unpaid losses for all eligible lines of business using its historical payment pattern on the most recent annual statement instead of the payment pattern determined by the Commissioner. Because new target is generally treated as a new corporation with its own accounting methods, new target is not permitted to apply old target's experience as a result of any Section 846(e) election made by old target. Thus, the proposed regulations do not provide any special rules under Section 846.

Proposed Effective Dates

In general, the regulations are proposed to be applicable when published as final.

Numerous people and organizations stepped forward to make comments on the proposed regulations. Noteworthy associations making comments were the Alliance of American Insurers, the American Insurance Association, the National Association of Independent Insurers, the National Association of Mutual Insurance Companies, the Reinsurance Association of America,[69] and the American Counsel of Life Insurers. Following are some of the areas of concern given in the public comments made: treatment of post-transaction losses incurred, ability to use of historical loss payment patterns, and retroactivity of the regulations.

> ***While the overall thrust of proposed regulations regarding the deemed sale or acquisition of an insurance company's assets under certain sections of the Internal Revenue Code are necessary, several changes should be made before the regulations become final. Post-transaction losses incurred, use of historical loss payment patterns, retroactivity of the regulations, and reinsurance transactions, will likely be the most pressing issues.***
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> Constance Parten, "Post-transaction losses, historical loss payments to be Debated at IRS Hearing," *BNA Daily Tax Report*, September 17, 2002, Page G-6.

Consolidated Returns Waiver

Revenue Procedure 2002-32

Rev. Proc. 2002-32[70] sets forth procedures for an automatic waiver of Section 1504(a)(3)(A), which generally provides that a corporation that ceased to be a member of a consolidated group may not be included in the group's consolidated return before the 61st month beginning after the first taxable year in which it left the group. Under the Rev. Proc., a corporation may be included in the consolidated return for the taxable year that includes the date on which Section 1504(a)(3)(A) would first apply to prevent the corporation from being included in a consolidated return if an automatic waiver of the general rule of 1504(a)(3)(A) is obtained. To obtain an automatic waiver, the deconsolidated corporation must be included in a timely-filed consolidated return of the

[69] Comments made by Scribner, Hall, and Thompson, LLP. See Writer Suggests Changes to Proposed Regs on Sale and Acquisition of Insurance Business, 2002 Tax Notes Today 181-17 (Sep. 18, 2002).

[70] Rev. Proc. 2002-32, 2002-20 I.R.B. 959.

affiliated group for the taxable year that includes the date on which the corporation rejoined the group. In addition, a statement that includes the information described in the Rev. Proc. must be attached.

Policyholder Surplus Account

GE Life Annuity and Assurance Company

Previously,[71] the Court had granted partial summary judgment for GE Life and denied the United States' cross motion for summary judgment. As a result of a joint stipulation between the parties, the court dismissed the remaining claims, and entered judgment[72] in favor of GE Life for $45.5 million plus statutory interest.

On April 29, 1986, Aon Corporation (Aon) purchased the stock of Life Insurance Company of Virginia (LOV), a stock company with insurance subsidiaries. (Ten years later, GE Capital acquired LOV from Aon, and renamed it GE Life.) On its last consolidated return, LOV elected under Section 338 to treat the stock sale as an asset sale. As a result of the election, LOV included the policyholder surplus account (PSA) in taxable income. Subsequently, LOV sought a refund on the basis that its inclusion of the PSA was erroneous because there had not been a triggering event as required under Section 815. Under Section 815 taxes on all or part of a life insurance company's PSA are only triggered by either distributions to shareholders which exceed the balance of shareholders surplus accounts; or PSA balances in excess of statutory maximums; or the company's failure to qualify as an insurance or life insurance company for one or two years, respectively. The court agreed with GE Life, ruling that the Section 338 election by the common stock purchaser of a life insurance company was not a triggering event under Section 815(d). The court held that the sale of the stock was not an actual distribution to the shareholders (LOV), thereby making it immaterial that the purchase price exceeded the PSA balance.

[71] *GE Life and Annuity Co. v. United States*, 127 F.Supp. 2d 794 (E.D.Va. 2000).

[72] *GE Life and Annuity Assurance Co. v. United States*, 89 A.F.T.R.2d 2002-1815, 2002 TNT 67-19 (E.D.Va. Mar 25, 2002).

Amortization of "Agency-force"

Globe Life and Accident Insurance Company

The Court of Federal Claims found that Globe Life and Accident Insurance Company (Globe) was not entitled to amortization deductions claimed under Section 167 because it failed to provide an accurate estimate of the useful life of its "agency force."[73]

Globe was originally NG Life Insurance of Delaware (NG Life). NG Life had been formed in 1979 by a subsidiary of Liberty National Life Insurance Company to acquire the stock of Globe Life and Accident Insurance Company (Old Globe). NG Life acquired all of the outstanding stock of Old Globe in July of 1980. Old Globe then distributed all of its property to NG Life in a tax free liquidation under Sections 332 and 334 (the IRS issued a private letter ruling confirming that the transaction was treated as Globe's acquisition of Old Globe's property under the law applicable at that time.) Immediately thereafter, NG Life changed its name to Globe.

Globe used the residual method to allocate basis among the assets acquired. No basis was allocated to the Old Globe's trade name, goodwill, "agency force" or other intangible assets. Subsequently, Globe claimed deductions under Section 167 in its tax returns for amortization of insurance-in-force. The IRS partially disallowed the insurance-in-force amortization deductions and assessed a deficiency. An agreement was reached by Globe and the IRS on the proper basis to be allocated to the insurance-in-force asset, but as a result, part of the purchase price remained unallocated. The IRS maintained that the amount was allocable to goodwill, while Globe contended that the amount was allocable to "agency force."

The court found that Globe failed to provide a reasonably accurate estimate of the useful life of its "agency force" and could not provide an accurate number of agents, therefore failing to meet its burden of proof. As a result, the Court denied Globe's claim. The Court did not address whether the amount was properly allocable to goodwill or "agency force."

[73] *Globe Life and Acc. Ins. Co. v. United States*, 54 Fed.Cl. 132 (2002).

Demutualizations

During 2002, the IRS released six private letter rulings granting mutual life insurance companies' tax-free conversions to stock corporations under Section 368(a)(1)(E).

Three private letter rulings 200213001,[74] 200213002,[75] and 200213003[76] were issued concurrently, and involve substantially identical facts. In each ruling, Company 1 is a property and casualty mutual insurance company and the common parent of a large group of affiliated corporations that file a consolidated return with one life insurance company. Company 2 is a property and casualty mutual insurance company with no subsidiaries. Company 3 is a mutual insurance company and the common parent of an affiliated group with no life insurance subsidiaries. PLR 200213002 also involved a foreign subsidiary, and PLR 200213003 involved a prior election to file a life-nonlife consolidated return. PLR 200224026 represents the typical demutualization scenario of the industry.

Private letter rulings 200208017[77] and 200240051[78] were issued separately; however, in both rulings, the IRS agreed that the conversions would be tax-free recapitalizations under Section 368(a)(1)(E).

> ***Prudential Financial Inc. said it is exploring the possibility of selling its personal auto-insurance and home-insurance operation. The move had been expected since the Newark, N.J., insurer converted from a policyholder-owned mutual company to a public company late last year. Prudential said it is circulating information about its auto- and home-insurance unit to assess interest in a sale. The unit generated $2.05 billion in revenue last year.***
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> Kaja Whitehouse, "Voluntary Benefits May Be Losing Their Appeal," *Wall Street Journal*, November 14, 2002, No Page Citation.

[74] PLR 200213001 (Mar. 29, 2002).

[75] PLR 200213002 (Mar. 29, 2002).

[76] PLR 200213003 (Mar. 29, 2002).

[77] PLR 200208017 (Feb. 22, 2002).

[78] PLR 200240051 (Oct. 4, 2002).

PLR200213001[79]

Companies 1 and 2 will be converted into stock insurance companies. Company 1 will then be controlled indirectly by newly formed Mutual Holding Company 1. Mutual Holding Company 1 will then acquire Companies 2 and 3 in reverse triangular mergers, whereby Mutual Holding Company 1 will create a sub (Merger Sub) to be merged into Company 2 with Company 2 remaining as the surviving entity. The same transaction of events will follow with Company 3. The IRS ruled that the Company 2 conversion and restructuring be treated as a recapitalization under Section 368(a)(1)(E), with no gain or loss recognized by Company 2 members on the exchange of membership interests for stock. The tax consequences of Company 2's reverse triangular merger will flow from Section 368(a)(2)(E) instead of Section 351.

PLR 200213002[80]

The facts surrounding PLR 200213002 were substantially the same as the prior PLR, except that Company 3 was a dual resident corporation, owning both a foreign and domestic subsidiary. The IRS again ruled that the conversion and restructuring of Company 3 will be a recapitalization under Section 368(a)(1)(E). In addition, the IRS ruled that any loss of the Company 3 foreign subsidiary would be treated as a dual consolidated loss and may not be used in the federal consolidated return.

PLR 200213003[81]

PLR 200213003 involved substantially the same facts as the prior PLR (including the presence of a dual resident corporation). The IRS issued similar rulings, and also ruled that any prior election to file a life-nonlife consolidated return under Section 1504(c)(2) would remain in effect, and that any loss of the Company 3 foreign subsidiary would be treated as a dual consolidated loss and may not be used in the federal consolidated return.

[79] PLR 200213001 (Mar. 29, 2002).

[80] PLR 200213002 (Mar. 29, 2002).

[81] PLR 200213003 (Mar. 29, 2002).

PLR 200208017[82]

Company and Subsidiary 1 are mutual life insurance companies. Subsidiary 1 and Company entered into an agreement to join together under a mutual holding company structure. Company will then proceed to be reorganized into Subsidiary 1's mutual holding company structure.

Company plans a four-step transaction as follows: First,Company will amend its Articles of Incorporation to authorize the issuance of capital stock. Second, the members of Company will become members of Mutual Holding (MH), their membership interests in Company will become membership interests in MH, and their membership interests in Company will be extinguished. Third, Company will issue shares of its capital stock to MH. Finally, MH will contribute all of the shares of Company to its subsidiary, SH. Based on the representations made by Company, the IRS ruled that the deemed transfer of Company membership rights by Company Members to Company in exchange for all the outstanding stock of Company will be a tax-free reorganization within the meaning of Section 368(a)(1)(E).

> ***Travelers distributed 210 million shares via an initial public offering at $18.50 a share. This works out to be the biggest U.S. insurance IPO ever, with a value close to $4 billion. The huge offering was a solid success, with the stock staying above issue price and then moving up to the $21 level. Sources on Wall Street indicate there was a great deal of institutional demand for Travelers, both in the United States and abroad. It has given an across-the-board boost to insurance stocks.***
>
> Thomas K. Meakin, "Travelers Sets Stage for Further IPOs," *National Underwriter*, April 29, 2002, Page 16.

PLR 200240051[83]

Company A, a mutual life insurance company, filed a consolidated return for the affiliated group of which it was the common parent. Company C was formed as a holding company for Company D and other companies that comprise the retirement savings operations of the Company E group.

82 PLR 200218017 (Feb 22, 2002).

83 PLR 200240051 (Oct. 4, 2002).

Company A and Company C were looking to merge. Company B would be formed as a wholly-owned subsidiary of Company C to complete the Merger. Company A would then convert into a stock company. Immediately following the Conversion, Company B would merge into Company A. Company A shares would be extinguished and policyholders would receive Company C Class A shares.

The IRS concluded that the conversion of Company A from a mutual insurance company to a stock insurance company will constitute a tax-free recapitalization and, therefore, qualify as a reorganization within the meaning of Section 368(a)(1)(E). Furthermore, the IRS ruled that Company A will be a party to the reorganization within the meaning of Section 368(b) and that no gain or loss will be recognized by Company A's policyholders on the exchange of their membership interests solely for Company A shares.

PLR 200224026

Mutual is a property and casualty mutual insurance company, controlled by its policyholders. Two holding companies are formed for the purposes of the proposed conversion transaction, Mutual Holding Company ("MHC") and Stock Holding Company ("SHC"). SHC issues two classes of common stock with different voting shares. The shares are all issued to MHC.

Mutual converts to a stock property and casualty company ("Stock"), with interests in Mutual automatically converting to interests in MHC and MHC holding all shares of Stock. MHC will then transfer all of the shares of Stock to SHC in exchange for an entire class of SHC stock.

Based on these representations, the IRS ruled the deemed exchange of membership interests in Mutual for stock in Stock to be a reorganization within the meaning of Section 368(a)(1)(E).

Excise Tax on Demutualization Proceeds

LTR 200219002[84]

Two trusts were established to provide group insurance coverage and other benefit programs to members of the Trust (Members) and their employees. One trust was established to provide hospital-medical insurance, while the other was formed to provide life insurance. The two trusts were eventually combined into one, designed to act as a conduit for payment of insurance premiums. Trust was part of a ten or more employer plan described in Section 419A(f)(6).

Trust discontinued offering medical, dental, life insurance, and long-term disability insurance. Insurance Company had been the underwriter for Trust's long-term disability insurance. Previously, Insurance Company was a mutual insurance company. Insurance Company demutualized and reorganized as a stock insurance company. Trust was issued shares of Holding Company common stock (Demutualization Proceeds) on account of its status as a policyholder. To wind up Trust's business in order to terminate, Trust passed the Demutualization Proceeds on to Members on a pro rata basis.

The IRS ruled that the payment of Demutualization proceeds by Trust to Taxpayer would not result in Taxpayer incurring an excise tax for disqualified benefits provided by a welfare benefit plan, pursuant to Section 4976(b)(1)(C).

[84] PLR 200219002 (May 10, 2002).

Chapter 7

International Developments

The Organization for Economic Cooperation and Development's (OECD) information exchange efforts with tax haven jurisdictions continued to lead the charge in stemming allegedly harmful international tax practices. The OECD effectively managed to persuade a number of "listed" domiciles to voluntarily agree to improve information sharing during 2002. The list of compliant jurisdictions now includes The Bahamas, Gibraltar, the U.S. Virgin Islands, Anguilla, the Turks and Caicos Islands, and Monserrat.

The OECD was joined in its efforts by the Department of the Treasury and the U.S. Congress. Both institutions were active on the international front in efforts to increase the transparency of transactions between U.S. and foreign corporations. The Treasury Department released an inversion study in May 2002 which stressed the need to review the competitiveness of the U.S. international tax law. The Treasury study led to the introduction of several Congressional bills aimed at curbing inversions and the continued implementation of information exchange agreements with tax haven countries.

The IRS issued a Revenue Procedure outlining domestic asset/liability percentages and domestic investment yields that foreign insurance companies are required to use to compute their minimum effectively connected net investment income. Also released was a Notice providing interim guidance on interest rates and foreign loss payment patterns for controlled foreign corporations. And, after more than a decade, the Federal Circuit Court of Appeals ruled in Travelers Insurance Company.[85]

> ***Worried about the weakened state of the global insurance industry, financial watchdogs on both sides of the Atlantic are stepping up surveillance of the sector. The 30 member countries of the Organization for Economic Cooperation and Development have reached an agreement to establish an information exchange on reinsurance companies within their jurisdictions, increasing oversight of a sector that acts as a linchpin within the international financial system – but that has been loosely controlled.***
>
> Charles Fleming, "Reinsurers to Get Greater Scrutiny in U.S., Europe," *Wall Street Journa*l, October 3, 2002, Page A10.

The Treasury Department also issued final and temporary regulations relating to U.S. taxation of foreign corporations under Sections 954, 874, and 4371. Final regulations under Section 954 adopt with modifications the proposed regulations issued in September 2000 and clarify the treatment of a controlled foreign corporation's distributive share of partnership income under subpart F. Temporary regulations under Sections 874 and 882 relax the standards under which the IRS will waive denial of deductions for late-filed tax returns of foreign persons. Final regulations on liability for insurance premium excise tax on insurance issued by a foreign insurer under Section 4371 conform the regulations to 1976 statutory amendments.

Finally, the U.S.-U.K. tax treaty was still awaiting ratification by the legislatures of both countries at the end of 2002, and the WTO ruled against the U.S. in the Foreign Sales Corporation/Extraterritorial Income Exclusion case. At the close of 2002, the Treasury Department and Congress were working together to come into compliance with WTO obligations.

[85] *Travelers Insurance Company v. United States*, 303 F.3d 1373 (Fed. Cir. 2002)

OECD Tax Havens Initiative

During 2002, the OECD released an updated list of jurisdictions that have been uncooperative with its campaign to eliminate harmful tax practices. Of the 35 countries cited on the original tax haven blacklist, issued in June 2000, only seven jurisdictions remain: Andorra, Liechtenstein, Liberia, Monaco, the Marshall Islands, Nauru, and Vanuatu.

The seven remaining jurisdictions face possible sanctions from the OECD's member states. The OECD itself lacks an enforcement mechanism to act against the countries directly. Because critics have charged that the OECD campaign against tax havens is flawed—as several of its own members have tax regimes that lack transparency or effective information exchange—it remains unclear if any action will be taken.

Treasury Inversion Study

The Department of the Treasury released its preliminary report on inversion transactions during 2002. The study concluded that, while a comprehensive review and reform of U.S. international tax rules is necessary, "As an immediate matter, careful attention should be focused on ensuring that an inversion transaction… cannot be used to reduce inappropriately the U.S. tax on income from U.S. operations."

> ***We believe it is important to recognize at the outset that meeting these dual goals will require legislation that makes appropriate and meaningful changes to our tax laws. If we begin our working group effort with the goal of preservation of the status quo, as was the case when the working group convened in 2000 in response to the WTO decision in the Foreign Sales Corporation case, then we do not believe the working group will reach a result that satisfies our dual goals of ensuring the competitiveness of U.S. businesses and complying with our WTO obligations.***
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> Kenneth W. Dam, Treasury Deputy Secretary in letter to Senators Max Baucus (D-MT) and Charles Grassley (R-IA) regarding the WTO decision, September 24, 2002, *Tax Notes Today*, 2002 TNT 186-15.

In the study, Treasury noted that, while "corporate inversion transactions are not new, there has been a marked increase recently in the frequency, size, and profile of the transactions," and that "these transactions can have significant adverse effects on the U.S. economy in the long term." As a result, Treasury suggested changes to the statutory and regulatory rules to ensure that "any transaction that results in a new foreign parent of a corporate group with U.S. operations does not serve to facilitate an inappropriate decrease in tax on the U.S. income of the U.S. operations." Among the suggested changes were limiting deductions for interest paid on foreign related party debt, rules requiring arm's length pricing for transfers of assets, and rules regarding cross-border corporate organizations.

Treasury also recommended a further examination of the U.S. tax disadvantages for U.S.-based companies that do business abroad, and acknowledged that "the U.S. international tax rules can operate to impose a burden on U.S.-based companies with foreign operations that is disproportionate to the tax burden imposed by our trading partners on the foreign operations of their companies."

Travelers Insurance Company

The Federal Circuit Court of Appeals ruled against Travelers Insurance Company[86] (Travelers) in a refund case which has been pending in Federal Claims Court for a decade. In the ruling, the Court reversed the Claims Court on two issues. First, the Federal Circuit held that the policyholders' share of income should have been excluded from life insurance company taxable income (LICTI) in computing the foreign tax credit limitation. Second, the Federal Circuit held that Travelers' method of translating foreign currency profits and losses from Canadian branch operations into U.S. dollars failed to clearly reflect income.

Foreign Tax Credit

In 1970, Travelers agreed to receive a 3 percent interest in an Indonesian oil exploration joint venture. Travelers paid taxes to Indonesia on the income

[86] *Travelers Insurance Company v. United States*, 303 F.3d 1373 (Fed. Cir. 2002).

and claimed foreign tax credits. The central dispute in the case was whether the policyholders' share of both foreign source LICTI and worldwide LICTI should be treated as an exclusion or a deduction for purposes of calculating the foreign tax credit limitation under Sections 841 and 904. The Federal Circuit held that the policyholders' share was an exclusion, and therefore should be excluded from the numerator and denominator of the foreign tax credit limitation formula, thereby dismissing the contrary theory advanced by the taxpayer and adopted by the trial court. The Circuit Court concluded that "The Code is clear on its face, and we are not charged with rewriting it to convert an exclusion into a deduction based on the theory proposed by the taxpayer and adopted by the Court of Federal Claims."

Foreign Currency Translation

Travelers derived income from underwriting and investment operations in Canada. On its U.S. tax returns, Travelers calculated its income from Canadian operations in Canadian dollars. Travelers combined those amounts with U.S. dollars from its other operations and made a foreign exchange adjustment to the combined figure, using the current, end-of-the-year exchange rate.

The Federal Circuit found that the trial court "erred when it concluded that no deference was due the IRS determination." However, the Federal Circuit found the IRS contention that Section 805 compels the basis of bonds, mortgages, and joint venture assets to be computed at historical year-end exchange rates to be untenable.

> ***Despite grumbling, European executives generally appear resigned to complying with a new U.S. law requiring top executives to sign oaths attesting to the accuracy of their financial results. Several European business groups have strongly criticized the rules, calling them an extra layer of regulation on companies whose activities are already well regulated by European authorities. But most global companies still want to tap the U.S. capital markets… and don't want to be seen as having anything to hide.***
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> Charles Goldsmith, Michael Schroeder, and Wade Lambert, "Europe's CEOs Bite Sarbanes Bullet," *Wall Street Journal*, August 22, 2002, Page A11.

Regulations

Final Section 954 Regulations

The IRS released[87] final regulations under Section 702 and subpart F which clarify the treatment of a controlled foreign corporation's (CFC's) distributive share of partnership income under subpart F. The final regulations include a new rule under Section 954(i) which clarifies the rule for income derived in the active conduct of an insurance business.

Under the regulations, gross income is characterized at the partnership level. If any part of the partnership's gross income would be subpart F income if received directly by partners that are CFCs, that part of the partnership's gross income must be separately taken into account by each partner under Section 702. To the extent that the separately stated income results in subpart F income to the CFC partner, it will be taken into account in determining the CFC's total subpart F income for the taxable year.

In addition, the final regulations add Treas. Reg. 1.954-2(a)(5)(ii) to clarify that for purposes of applying the special rule for income derived in the active conduct of an insurance business under Section 954(i), the exception will apply only if the CFC partner is a qualifying insurance company, as defined in Section 953(e)(3), and the partnership generates qualified insurance income, as defined in Section 954(i)(2). Examples have been included in the final regulations that illustrate the operation of these rules.

Section 874 Regulations

The IRS issued[88] temporary regulations under Sections 874 and 882 which relax the standards under which it will waive denial of deductions for late-filed tax returns of foreign persons. The new rules apply to waiver requests submitted on or after January 29, 2002 to all open years.

Foreign taxpayers that fail to timely file income tax returns are denied the right to claim deductions and credits unless the IRS waives the denial.

[87] 67 Fed. Reg. 48020 (Jul. 23, 2002).

[88] 67 Fed. Reg. 4173 (Jan. 29, 2002), corrected at 67 FR 12471 (Mar. 19, 2002).

Under the regulations in effect prior to the temporary regulations, a waiver could be granted only in "rare and unusual circumstances" and if the taxpayer demonstrated good cause for the failure to file. The new rules were issued because the prior rules discouraged noncompliant taxpayers from coming into compliance. Under the new regulations a waiver will be granted if the taxpayer acted reasonably and in good faith in failing to file an income tax return, based on the factors enumerated in the regulations.

> ***The recent weakness in Japanese stocks, on which Japanese insurers depend for investment returns, means the insurance companies are falling far short of the income needed to cover guaranteed yields they are obligated to pay on certain policies. Ratings agencies and analysts say that without an across-the-board cut in these guaranteed yields to policyholders, many of the insurers could be heading for insolvency.***
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> Iain McDonald, "Life-Insurance Industry in Japan Faces Possibility of Cutting Yields," *Wall Street Journal*, July 31, 2002, Page B8A.

Section 842(b) Percentages for Foreign Insurers

Rev. Proc. 2002-58[89] provides guidance on the domestic asset/liability percentages and domestic investment yields needed by foreign insurance companies and foreign property and liability insurance companies to compute their minimum effectively connected net investment income under Section 842(b). The procedure also provides for computing foreign insurance companies' liabilities for the estimated tax and installment payments of estimated tax for taxable years beginning after December 31, 2000.

For the first taxable year beginning after December 31, 2000, the relevant domestic asset/liability percentages for life insurance companies and property and liability insurance companies are:

130.7 percent for foreign life insurance companies, and

192.3 percent for foreign property and liability insurance companies.

[89] Rev. Proc. 2002-58, 2002-40 I.R.B. 644.

For the first taxable year beginning after December 31, 2000, the relevant domestic investment yields for foreign life insurance companies and for foreign property and liability insurance companies are:

6.0 percent for foreign life insurance companies, and

5.1 percent for foreign property and liability insurance companies.

The revenue procedure is effective for taxable years beginning after December 31, 2000.

Section 4371 Regulations

In November 2002, the IRS finalized[90] regulations under Section 4371 which were originally proposed in January 2002.

The final regulations generally adopt the language of the proposed regulations, providing that anyone who makes, signs, issues, or sells any of the documents and instruments subject to the tax, or for whose use or benefit they are made, signed, issued, or sold, is liable for the excise tax under Section 4371. The liability attaches at the time payment is made to the foreign (re)insurer. Failure to pay the tax results in a penalty equal to double the amount of tax.

The final regulations also expand on the applicability of the excise tax in reinsurance arrangements. Where a reinsurance arrangement, other than assumption reinsurance, is subject to the excise tax, the final regulations specifically exclude the underlying insured from the applicability of the excise tax. The final regulations are applicable with respect to premiums paid on or after November 27, 2002.

> ***Not since 1992 – when Hurricane Andrew battered Florida – have so many insurers and reinsurers flocked to the island nation of Bermuda. Then, as now, the new insurers and their financial backers looked at a bad situation for the industry – record insured losses – and saw the potential for good – that is, profits.***
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> David Hilgen, "Bermuda Bound," *Best's Review*, March 1, 2002, Page 20.

[90] 67 Fed. Reg. 70845 (Nov. 27, 2002).

Interim Guidance on Interest Rates

Notice 2002-69[91] provided interim guidance on determining the interest rates and appropriate foreign loss payment patterns to be used by controlled foreign corporations (CFCs) in calculating their qualified insurance income under Section 954(i).

Because a qualifying insurance company ("QIC") does not file an annual statement, a QIC should use the undiscounted unpaid losses reflected on the statement filed with a foreign regulatory authority. If no statement or report is filed with a foreign regulatory authority, or if it does not reflect undiscounted unpaid losses, a QIC should use the undiscounted unpaid losses used for financial reporting purposes in the United States.

In addition, the Notice gave two options for determining the appropriate foreign loss payment pattern. Until final regulations under Section 954(i) are issued, controlling shareholders of a QIC may rely on Notice 2002-69 to determine the interest rates and appropriate foreign loss payment patterns of a QIC for purposes of Section 954(i). Shareholders also may apply the guidance to prior taxable years.

> ***Once middle-class Chinese have homes and steady incomes, they will want to insure them. That, at least, is the bet of foreign life and property insurers, among the earliest financial-service companies to enter China's markets. Late last month New York Life announced a partnership with Haier, China's leading home-appliance manufacturer, which is clearly mimicking part of General Electric's business model.***
>
> Eric Roston and Daren Fonda, "China's New Party; The world's most populous nation is finally a member of the global free-trade club," *Time Magazine*, January 28, 2002, Page B6.

Effectively Connected Income

The IRS released TAM 200210028,[92] concluding that Taxpayer was not entitled to relief under Section 7805(b) from the retroactive application of

[91] Notice 2002-69, 2002-43 I.R.B. 730.

[92] Technical Advice Memorandum 200210028 (Mar. 8, 2002).

the technical advice memorandum requiring Taxpayer to determine its effectively connected income under the standards set forth in Section 864(c).

Taxpayer, a foreign life insurance company, issued life insurance contracts in the U.S. and conducted its U.S. life insurance business through a U.S. branch. Taxpayer's state of domicile required Taxpayer to maintain trusteed assets and deposits in the U.S. sufficient to satisfy all potential claims of its U.S. policyholders.

Taxpayer did not include income from its non-trusteed assets on its U.S. federal income tax return as effectively connected income. Taxpayer argued that income attributable to the non-trusteed assets is not effectively connected income because it is not included on its NAIC statement.

The IRS concluded that Taxpayer's argument that NAIC statements are determinative of effectively connected income has never been ratified by judicial holding or agency action; therefore, Taxpayer could not claim detrimental reliance on its interpretation of law. As a result, Taxpayer failed to show that retroactive relief under Section 7805(b) was warranted.

The U.S.-U.K. income tax treaty, which is awaiting the legislative approval of both countries, denies treaty benefits under, or as part of, a conduit arrangement. Patricia Brown, Treasury's deputy international tax counsel, has said that the anticonduit rule is "unique and unlikely to be part of our treaty practice" and that Treasury does not "anticipate using this approach in the future."

Kevin Bell, "Proposed U.K.-U.S. Tax Treaty's Anticonduit Rule Unique," *Tax Notes Today*, 2002 TNT 49-11.

Treaty Updates

U.S. – U.K. Treaty Update

The U.S. – U.K. income tax treaty, which was still awaiting the legislative approval of both countries at the end of 2002, denies treaty benefits for dividends, interest, royalties, and premiums on U.S. risk insurance or reinsurance policies paid under, or as part of, a conduit arrangement.

Under the treaty, a conduit arrangement is a transaction where a resident receiving treaty-benefit income pays "substantially all" of that income to a third-country resident that would not have been entitled to the benefits if it had received the income directly. For example, if a U.K. insurer had an arrangement whereby it received income from a U.S. insured that would otherwise qualify for a waiver of the U.S. insurance excise tax, and then paid that income out to a Bermuda reinsurer, the arrangement would be considered a conduit arrangement, and treaty benefits would be denied.

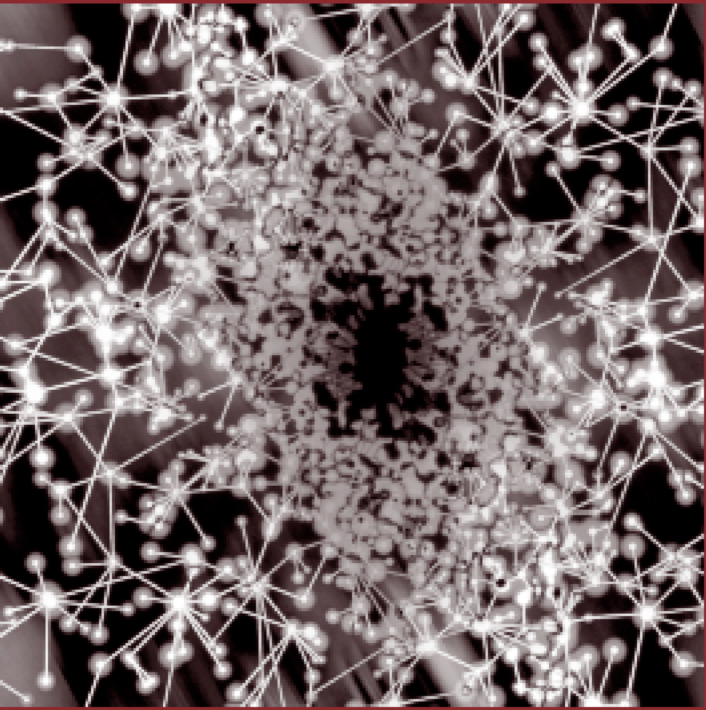
> ***United Kingdom financial regulators relaxed a key rule dealing with insurers' solvency, partly because of worries about how hedge funds would react to the recent drop in share prices. Without such a move, the authorities feared, hedge funds could push stock prices down so far that domestic insurance companies would be forced to sell shares, thereby accelerating the decline. The Financial Services Authority on Friday said insurers no longer would have to ensure that they could withstand a 25% drop in stock markets at any point and still be able to meet their financial obligations. Rather, the new resiliency test will require them to merely withstand a 25% drop in the average level of stock markets over the previous three months.***
>
> Catherine Taylor, "Solvency Rule Affecting Insurers Is Relaxed in U.K."
> *Wall Street Journal*, July 1, 2002, Page C14.

U.S. – Mexico Treaty Update

In late November, the United States and Mexico signed a protocol amending and modernizing the U.S.-Mexico income tax treaty, which dates from 1992. The new protocol would lower taxes on cross-border dividend payments, update the operation of both U.S. and Mexican foreign tax credits, and give Mexico the treatment equivalent to the best the United States has negotiated with any other tax treaty partner. Treasury Deputy Secretary Kenneth Dam said that the "The new protocol… reflects the close economic relationship between our two countries."[93]

[93] Chuck Gnaedinger, "Treasury Announces Update to U.S.-Mexico Income Tax Treaty," *Tax Notes Today*, November 26, 2002.

Chapter 8



Blue Cross & Blue Shield Entities

Tax developments during 2002 in the Blue Cross Blue Shield (BCBS) arena primarily involved two areas: the deductibility of intangible assets Fresh Start basis and the tax consequences of BCBS mergers & acquisitions activity.

Intangibles Fresh Start Basis

Two BCBS organizations claiming deductions for intangible assets pursuant to the Fresh Start Basis transition rule of Section 1012(c)(3)(A)(ii) were represented in the Courts. Trigon Insurance Company[94] (formerly Blue Cross Blue Shield of Virginia) ultimately lost its District Court case; however, the ruling could be favorable for subsequent taxpayers who seek to deduct losses on intangible abandonments, provided that the taxpayers meet the burden of proof in determining the value of their losses. Capital Blue Cross[95] of Pennsylvania and the government filed petitions in the Tax Court for a redetermination of a 1994 notice of deficiency relating to the Fresh Start Basis transition rule. That case was not decided as of the close of the year.

94 *Trigon Insurance Company (Formerly Blue Cross and Blue Shield of Virginia) v. United States of America* 2002-2 USTC ¶ 50,580 (Aug. 09, 2002).

95 *Capital Blue Cross and Subsidiaries v. Commissioner of Internal Revenue* No. 13322-01 (13 Nov 2001).

Trigon Insurance Company

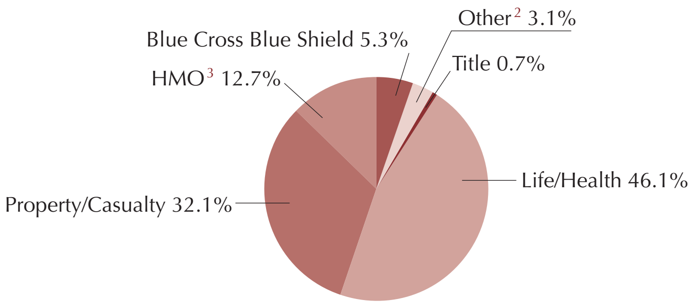
In August 2002, the U.S. District Court for the Eastern District of Virginia ruled that Trigon Insurance Company[96] could not deduct losses from cancelled subscription and provider contracts because it did not meet its burden of proof when valuing the contracts. However, in the Taxpayer's favor, the Court found against the Government on several accounts, concluding that: subscriber contracts are identifiable, severable individual assets can produce value and be transferred for consideration, and the Fresh Start Basis rule is not limited to gains or losses arising from sale or exchange transactions. Ultimately, the Court ruled that a deduction for losses on intangible abandonments is permissible. In coming to its conclusions, the Court found that:

- The judicial history indicates that contractual relationships have historically been recognized as assets.
- The contracts are assets because they produce value and may be transferred for consideration.
- As assets, the contracts are eligible for a Fresh Start Basis.
- Statutory language does not distinguish applicability of the Fresh Start Basis to gains and losses on sales or exchanges only.
- Worthlessness of a contract is an appropriate basis for abandonment.
- Each contract is an identifiable and severable asset.
- Although no market exists for individual contracts, they do have a fair market value.

While Trigon won a legal victory, the Company lost the case when the Court took exception with the accuracy and reliability of Trigon's valuation of the contracts. The Court found, in particular, that **(1)** the number of contracts valued was inaccurate, **(2)** the method used to value contracts was not checked for validity, although validity could have been checked, **(3)** inputs into the model used to calculate the value were inaccurate, **(4)** the model did not consider all price influences such as competition, industry changes and price sensitivity and, **(5)** the model, while sound, was not correctly applied.

[96] *Trigon Insurance Company (Formerly Blue Cross and Blue Shield of Virginia) v. United States of America* 2002-2 USTC ¶ 50,580 (Aug. 09, 2002).

PREMIUMS BY TYPE OF INSURER, 2000[1]



[1] Gross direct premiums. Total premiums for 2000 were $956.8 billion.

[2] Includes hospital, medical and dental indemnity, fraternal, limited benefit plans, and all other insurance.

[3] Health maintenance organizations.

Insurance Information Institute, *The Financial Services Fact Book 2003*, Page 4.

Capital Blue Cross

In November 2001, Capital Blue Cross (CBC)[97] filed a petition in the Tax Court for a redetermination of a 1994 IRS notice of deficiency.

The IRS notice of deficiency disallowed CBC's deductions claimed for the intangibles Fresh Start basis in the 1987-1994 years. The result of the disallowance of the intangibles abandonment deductions was a reduction to the NOL and AMT credit carryovers to 1994, as well as an overall increase in taxable income for the 1994 year. In the notice of deficiency, the IRS determined that intangibles abandonments deductions were not allowable on each of the following bases:

- The Taxpayer failed to establish that an abandonment had occurred during the year;
- Each CBC insurance contract is a component of a single, indivisible intangible asset, and therefore, no current loss deduction is available until all such subscribers are lost;

[97] *Capital Blue Cross and Subsidiaries v. Commissioner of Internal Revenue* No. 13322-01 (13 Nov 2001).

- The Fresh Start Basis adjustment is available only for gains and losses arising from sales and exchanges;
- Claiming abandonment deductions on an annual basis is tantamount to claiming an annual amortization deduction for the Fresh Start Basis, which is specifically prohibited by Section 1012; and,
- The Taxpayer changed its method of accounting for the Fresh Start intangible basis without seeking the consent of the Commissioner.

CBC argued that the 1994 deficiency determined by the IRS is based upon several errors, arguing that the intangibles abandonments are evidenced by closed and completed transactions and are supported by accurate and appropriate valuations, and that the government's remaining legal arguments are not valid. A decision on the case is expected during the 2003 year.

Tax Consequences of BCBS Mergers & Acquisitions Activity

Revocation of Ruling on Conversion Payment Deductibility

In Private Letter Ruling 200228016 the IRS revoked LTR 9853007, which permitted the taxpayer to claim as an ordinary and necessary business expense under Section 162 the amount paid to a charitable foundation as a conversion payment. The IRS provided little guidance as to the reasons behind the revocation, simply stating that the ruling was not in accordance with the current views of the IRS. The IRS did use its discretionary authority under Section 7805(b) to limit the retroactive effect of the ruling, thereby allowing the taxpayer in LTR 9853007 to maintain its deduction. The IRS issued a second ruling addressing the deductibility of conversion payments, Technical Advice Memorandum 200126008. It is our understanding that the taxpayer to which the TAM was issued has also been contacted regarding its revocation.

Material Change in Operations or Structure

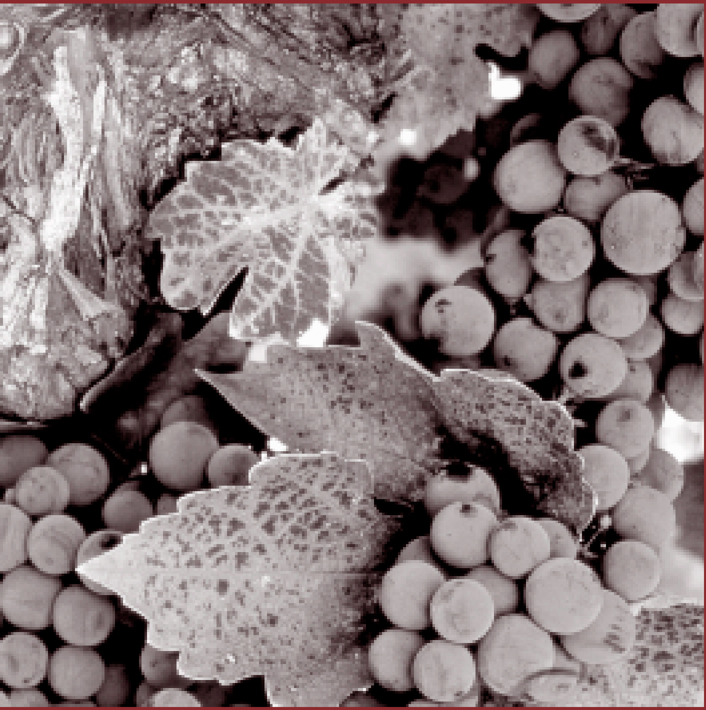
In 2002, the IRS issued a ruling regarding the material change concept contained in Section 833. The IRS has historically been very reluctant to give guidance on what actions cause a material change in operations or structure.[98] In Private Letter Ruling 200201004, the IRS concluded that the merger of a BCBS organization with another insurance company is not a material change in operation or structure pursuant to Section 833(c)(2).

Parent, a BCBS company, wished to acquire the insurance licenses of Acquiring while remaining a mutual company under state laws. State law, however, prohibited the licenses from being transferred, thereby forcing Parent to merge into Acquiring with Acquiring remaining as the surviving entity. To accomplish the merger, Parent would first purchase all of the Acquiring stock from an unrelated corporation. Next, Parent would purchase Acquiring's insurance policies for cash. After Acquiring became a mutual company, Parent would merge into Mutual Acquiring in a Section 368(a)(1)(A) merger with Mutual Acquiring surviving. Finally, Mutual Acquiring would change its name to Parent's name.

This ruling is significant for several reasons. First, it allowed an existing BCBS organization to merge into a multi-licensed mutual without a material change in operations or structure, although significant representations had to be made on the part of the taxpayer. Second, it expressly provided that no opinion was being issued on whether writing new types of insurance in Mutual Acquiring after the merger would result in a material change operations. Further, no consideration was given to the consequences of Mutual Acquiring writing lines of business outside of the health insurance arena. Finally, the IRS also ruled that mutualization would not affect Acquiring's tax attributes.

[98] A material change in operations or structure leads to the loss of application of Section 833 to a BCBS organization.

Chapter 9



Insurance Products

Following a year of negative press, corporate-owned life insurance (COLI) and split dollar insurance products received legislative, judicial, and Treasury action during 2002 – all considered unfavorable for the insurance industry and its clients. In a blow to companies appealing COLI decisions, the U.S. Supreme Court denied certiorari in *Winn-Dixie*. Additionally, Camelot Music lost in the Third Circuit, bringing the score to IRS 5, taxpayers 0. Still pending at the end of 2002 were the Dow Chemical suit before the District Court in Michigan, the Ameritech case before the Tax Court, and AEP's appeal to the Sixth Circuit. In the face of favorable court rulings, the IRS announced late in the year that it would end its appeals settlement initiative for COLI cases.

Several unfavorable articles about "Janitor Insurance" in the Wall Street Journal during April and May 2002 prompted Congressman Green (D-TX) to introduce H.R. 4551, the "Life Insurance Employee Notification Act," requiring an employer to notify an employee in writing upon the purchase of an employer-owned insurance policy on the employee's life when the beneficiary is not the individual who is the subject of the policy. Although the bill never came to a vote, it was indicative of the mood surrounding COLI during 2002.

Split dollar life insurance received substantial attention from the IRS and from Congress. New proposed regulations were preceded by Notice 2002-8, announcing IRS intent to publish proposed regulations, and were followed by Notice 2002-59, explaining the standard for valuing current life insurance protection under a split-dollar arrangement.

Also during 2002, the IRS issued a revenue procedure on modified endowment contracts, a revenue procedure expanding a taxpayer's ability to consolidate insurance contracts tax-free, final Section 1275 regulations, two private letter rulings finding that companies issuing extended service contracts are insurance companies, two waivers under Section 7702, a legal memorandum regarding the capitalization of new insurance product expenses, and a private letter ruling relating to variable life insurance contracts.

Corporate-Owned Life Insurance

> ***Claiming losses of more than $150 million, Wal-Mart has filed a lawsuit against AIG Life and Hartford Life charging negligence, misrepresentation and breach of fiduciary duties related to the sale of corporate-owned life insurance policies. In August 2002, Wal-Mart, under threat of litigation, resolved a dispute with the IRS regarding the tax treatment of the policies resulting in a substantial, unanticipated tax liability.***
>
> Steven Brostoff, "Wal-Mart Sues AIG Life and Hartford Life Over COLI Policies," *National Underwriter*, September 16, 2002, Page 12.

Winn Dixie

The U.S. Supreme Court declined to review an Eleventh Circuit decision which held that loans that Winn-Dixie[99] took against whole life insurance policies it purchased on the lives of 36,000 full-time employees were substantive shams. Winn-Dixie, therefore, was not entitled to deduct interest and fees incurred in borrowing against the cash value of the policies to pay premiums.

[99] *Winn-Dixie Stores Inc. v. Commissioner*, 254 F.3d 1313 (11th Cir. 2001), *cert. denied*, -- U.S. --, 122 C.Ct. 1537 (2002).

The Eleventh Circuit had previously affirmed the Tax Court's 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 that the COLI program lacked economic substance to be respected for tax purposes.

> ***Public criticism over the sale of corporate-owned life insurance has regulators reexamining how the product is regulated. As a starting point, a 10-year old guideline developed by the NAIC will be reexamined and possibly revamped. However, regulators who are part of the NAIC's COLI working group, have left open the possibility of developing a whole new model law that states can adopt to enforce how the product is sold and disclosed.***
>
> Jim Connlly, "Public Criticism of COLI Sales Spurs Regulators to Revamp Guidelines," *National Underwriter*, July 29, 2002, Page 41.

Camelot Music[100]

Following the denial of certiorari for Winn-Dixie, the Third Circuit affirmed the decision of the U.S. District Court in Delaware, concluding that Camelot Music's COLI program was a sham in fact. The Third Circuit found that the program as a whole lacked economic substance, and imposed accuracy-related penalties. Unlike the district court, the Third Circuit did not find the loading dividends to constitute shams in fact.

The case involved a broad-based leveraged COLI program used to finance active medical benefits. The district court, after disposing of two defenses raised by Camelot (i.e., compliance with the four-out-of seven rule provisions as a *per se* defense and the impropriety of challenging these policies for periods prior to those affected by the HIPAA legislation) conducted an exhaustive analysis of the underlying COLI program and concluded that it was both a sham in fact and a sham in substance.

[100] *In re CM Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002).

The Third Circuit looked at two aspects of Camelot's COLI transaction to determine whether it had economic substance: its objective economic substance and the subjective business motivation behind it. The court concluded that the plan lacked economic substance because the transaction "had no net economic effect on Camelot's financial position" and that it failed the subjective prong because all parties focused solely on the tax benefits the plan provided. The court specifically noted that the most damning piece of evidence was that the marketing information showed that, absent tax deductions, the plan would lose money.

> ***The Camelot decision hands another victory to the IRS, which has sought to deny the deductions at a number of companies that it says illegally took hundreds of millions of dollars in deductions. The IRS has said it is investigating at least 85 companies with potential tax liabilities of a combined $6 billion, and has sought to recover millions of dollars in similar deductions taken by companies such as R.R. Connelley & Sons Co., Winn-Dixie Stores Inc. and Wal-Mart Stores Inc.***
>
> Theo Francis, "Court Finds 'Janitors Insurance' A Tax Sham at Camelot Music," *Wall Street Journal*, August 23, 2002, Page C13.

Announcement 2002-96

Announcement 2002-96[101] terminated the settlement initiative for broad-based leveraged COLI plans purchased after June 20, 1986. In the Announcement, the IRS stated that it will "vigorously defend or prosecute all future COLI litigation."

In August 2001, the IRS implemented a coordinated settlement initiative for broad-based COLI cases that permitted taxpayers to settle if they agreed to concede 80 percent of the interest deductions claimed for their COLI plans. In October 2002, having won every COLI case brought to court, the IRS determined that the settlement initiative would be terminated, subject to a 45-day window within which taxpayers would be permitted to enter into the settlement arrangement.

[101] Announcement 2002-96, 2002-43 I.R.B. 756.

Formal notification of the IRS's termination of the settlement initiative was made by letter to taxpayers identified with COLI Plans. In order for taxpayers to qualify for the settlement initiative, a written offer to settle had to be delivered to the IRS within 45 days after the date of the letter. At the close of 2002, it was unclear whether, or under what circumstances, the IRS would begin to impose penalties on cases that remained outstanding.

> ***Sen. Jeff Bingaman (D-NM) said he will introduce legislation to prevent companies from taking out life insurance on rank-and-file workers simply to glean tax-free income. Reps. Gene Green (D-TX) and Nancy Pelosi (D-CA) also held a news conference to discuss legislation Mr. Green introduced last week that would require employers to tell employees and former employees and their families whether it has coverage on their lives, and how much. The bill, HR 4551, has more that 30 co-sponsors.***
>
> Ellen E. Schultz and Theo Francis, "Senator to Target Tax Boon to Firms Insuring Workers," *Wall Street Journal*, May 3, 2002, Page A2.

TAM 200213010

Shortly before the *Winn-Dixie* ruling, the IRS released TAM 200213010,[102] concluding that Taxpayer purchased its COLI programs pursuant to a plan that lacked economic substance and business purpose. Because the policies were shams in substance, interest incurred on the COLI policy loans was not deductible.

Once again, proper documentation, or the lack thereof, coupled with "tax-motivated" documentation and/or marketing materials, was the Achilles heel. The IRS had little difficulty determining that Taxpayer focused solely on tax benefits and ignored solid business purpose support and documentation. The Taxpayer argued that the plans had economic substance because **(1)** the transactions materially changed its economic position because Taxpayer paid premiums during four of the first seven policy years **(2)** had it not leveraged the policies, Taxpayer would receive total death benefits, less expenses.

[102] Technical Advice Memorandum 200213010 (Mar. 29, 2002).

The IRS disagreed with Taxpayer that the plans provided Taxpayer with any economic benefits aside from generating tax deductions. The IRS also disagreed with Taxpayer's assertion that, because it would receive death benefits had it not borrowed from the policies, the plans possessed economic substance.

> ***Many American banks, taking advantage of relaxed restrictions by federal regulators, are getting a boost in their profits from tax-free income they earn from life-insurance policies they take out on their employees. Hundreds of banks have taken out insurance policies on employees with the company as the beneficiary, according to a review of regulatory filings. Some have received as much as 10% to 15% of their net income from the tax-free earnings they get on premiums they pay on the policies, according to insurance consultants who are familiar with the practice.***
>
> Theo Francis and Ellen E. Schultz, "Many Banks Boost Earnings With 'Janitors' Life Insurance"
> *Wall Street Journal*, April 26, 2002, Page A1.

FSA 200202028

The IRS issued two field service advice rulings regarding COLI. In FSA 200202028[103] the IRS concluded that loans on COLI contracts purchased before June 20, 1986 should not be aggregated with debt after that date for determining whether the $50,000 limit of former Section 264(a)(4) had been exceeded.

Prior to June 20, 1986, Taxpayer purchased COLI to fund deferred compensation plans for certain employees. After June 20, 1986, Taxpayer purchased additional life insurance contracts insuring the lives of the same employees. Taxpayer borrowed against the policies to fund premium payments as due. The loan interest rates were less than Moody's Corporate Bond Yield Average.

In making its decision, the IRS addressed two fact patterns. In both fact patterns, the loans on policies insuring the same individual and purchased after June 20, 1986, were in excess of $50,000. Under both fact patterns, the IRS

[103] Field Service Advisory 200202028 (Jan. 11, 2002).

determined that indebtedness secured by policies purchased before the effective date should not be aggregated with those purchased after June 20, 1986 for purposes of determining whether the indebtedness to one individual exceeds $50,000.

FSA 200210010

In FSA 200210010,[104] the IRS concluded that the taxpayer did not fail the 4 of 7 exception under Section 264(d)(1) where no premiums were paid after the end of the third policy year.

Taxpayer purchased corporate-owned life insurance contracts on the lives of its employees. Through the third policy year, Taxpayer borrowed against the surrender value of the Plan policies as soon as the aggregate premium due was paid. Taxpayer stopped paying premiums on the Plan policies in the fourth policy year, and the policies lapsed.

The IRS found that failure to complete the full seven years with its mandatory payment of four premiums did not indicate that Taxpayer did not satisfy Section 264(c)(1) because the transition rules provided that a contract was not to be treated as failing the 4 out of 7 exception of prior Section 264(c)(1) solely by reason of a lapse occurring after October 13, 1995.

> ***The Treasury Department proposed rules that would tax executives for life-insurance policies widely used in compensation packages for top managers. Unlike the Clinton plan, the Bush administration proposal wouldn't affect existing arrangements or those put into effect until at least Oct. 23, when the IRS holds a hearing on the matter. Treasury officials said they didn't think it was appropriate to impose tax restrictions retroactively, when the government had allowed split-dollar packages to flourish for decades. The insurance industry cheered the decision to grandfather those policies.***
>
> Rob Wells, "Treasury Proposes Rules to End Executives' Insurance Tax Breaks," *Wall Street Journal*, July 5, 2002, Page A2.

[104] Field Service Advisory 200210010 (Mar. 8, 2002).

Split-Dollar Life Insurance

Proposed Split-Dollar Regulations

The IRS released[105] proposed regulations on the taxation of split-dollar life insurance arrangements. The proposed regulations apply for purposes of Federal income, employment, and gift taxes.

The proposed regulations define a split-dollar arrangement as any arrangement between an owner and a non-owner of a life insurance contract where either party pays all or part of the premiums, and one of the parties will recover those premiums from the proceeds of the contract. Under the regulations, a split-dollar arrangement does not include group plans where the only parties are the policy owner and the life insurance company. However, the IRS does note that the definition of "split dollar life insurance" is intended to apply broadly. The proposed regulations also provide two mutually exclusive regimes for taxing split-dollar life insurance arrangements—the **economic benefit regime** and the **loan regime**.

The **economic benefit regime** provides that economic benefits provided to a non-owner must be accounted for by both the owner and the non-owner. The value of the economic benefits, less any consideration paid by the non-owner to the owner, is treated as transferred from the owner to the non-owner. The tax consequences of the transfer depend on the relationship between the owner and the non-owner; therefore, the transfer may be payment of compensation, a distribution under Section 301, a gift, or a transfer having a different tax character. Specific rules were given for equity and non-equity split dollar arrangements.

The **loan regime** provides that a payment made under a split-dollar life insurance arrangement is a split-dollar loan and the owner and non-owner are treated as borrower and lender if **(1)** the payment is made directly or indirectly by the non-owner to the owner; **(2)** the payment is a loan under general principles of Federal tax law; and **(3)** the repayment is to be made from, or is secured by, the policy's death benefit proceeds or its cash surrender value.

[105] 67 Fed. Reg.45415 (July 9, 2002).

The proposed regulations provide rules for below-market split-dollar loans, split-dollar loans with contingent payments, and split-dollar loans with stated interest that is subsequently waived, cancelled, or forgiven.

> ***The $25 million policy that CSX Corp. promised in 2001 to buy for John Snow, now President Bush's nominee for Treasury secretary, is typical. The railroad conglomerate agreed to buy the policy, which would cost about $5 million, within seven years, according to company filings. At the end of the period, Mr. Snow would own a policy paying $25 million at his death, and which could be liquidated for its cash value – essentially the initial $5 million in premiums plus investment earnings on that money. (CSX hadn't yet bought the policy when Mr. Snow was nominated for the Treasury post; the company instead plans to give him the $5 million in cash.)***
>
> Theo Francis and Ellen E. Schultz, "Insurers Move to Protect Executive Policy,"
> *Wall Street Journal*, December 30, 2002, Page C1.

Notice 2002-8

Notice 2002-8 [106] provided guidance with respect to arrangements entered into before the effective date of the above regulations. The Notice also revoked a prior Notice issued in 2001, which had provided interim guidance regarding the tax treatment of parties entering into split-dollar life insurance arrangements. Treasury had received several comment letters suggesting that the 2001 Notice be revoked, that the Section 7872 imputed interest rules were too narrow, and that its application of Section 83 was in conflict with Section 72. While Notice 2002-8 revoked the 2001 Notice, it also foreshadowed split dollar regulations very similar to those mentioned in the earlier Notice.

Notice 2002-8 provided guidance regarding the valuation of current life insurance protection under a split-dollar life insurance arrangement, under qualified retirement plans, and under employee annuity contracts.

[106] Notice 2002-8, 2002-4 I.R.B. 398.

> ***At a conference in Washington September 13 Treasury's Michael Doran said the loan prohibitions of recently enacted corporate reform legislation won't affect IRS guidance on the loan treatment of certain split-dollar arrangements. Doran said that whether the new law applies to split-dollar arrangements is a question for the SEC because the SEC has jurisdiction to interpret the language. The new law takes an "all or nothing" approach with loan arrangements – it's criminal or not criminal. Doran said it is reasonable to ask if it can really be the case that if one puts the employer's name down as the owner of a split-dollar policy it won't be a crime, but if the employee's name is listed as owner it will be a crime.***
>
> Christine Harris, "Sarbanes-Oxley Won't Affect IRS Approach to Split-Dollar Rules," *Tax Analysts Tax Notes Today*, 2002 TNT 179-4.

Notice 2002-59

Following the release of the proposed split-dollar regulations, the IRS issued Notice 2002-59[107] addressing split-dollar life insurance arrangements where parties attempt to avoid taxes by using artificially high current term insurance rates, prepayment of premiums, or other techniques to understate the value of policy benefits. The Notice explained the standard for valuing current life insurance protection under a split-dollar arrangement.

In the Notice, the IRS stated that, under certain split-dollar life insurance arrangements, one party holding a right to current life insurance protection uses inappropriate techniques to confer policy benefits other than life insurance protection on another party. The use of such techniques to understate the value of policy benefits distorts the income, employment, or gift tax consequences of the arrangement and is not permitted.

Notice 2002-59 makes it clear that if one party has any right to current life insurance protection, "neither the premium rates in Table 2001 nor the insurer's lower published premium rates may be relied upon to value such party's current life insurance protection for the purpose of establishing the value of any policy benefits to which another party may be entitled."

[107] Notice 2002-59, 2002-36 I.R.B. 481.

Tax-Free Exchanges

Revenue Ruling 2002-75 [108]

The IRS expanded the taxpayer's ability to consolidate insurance contracts without recognizing gain or loss in describing a situation where the transfer of an entire annuity contract into another pre-existing annuity contract qualified as a tax-free exchange under Section 1035. In a similar 1996 ruling,[109] the IRS ruled that a proposed exchange of two non-participating flexible premium life insurance policies issued by separate companies for one non-participating flexible premium variable deferred annuity contract issued by a third company would be a tax-free exchange. Likewise, the IRS ruled in PLR 9644016 [110] that an exchange of one annuity contract for two annuity contracts qualified for nonrecognition treatment under Section 1035(a)(3).

Under the facts of the ruling, A owns Contract B, an annuity contract issued by Company B, and Contract C, an annuity contract issued by Company C. A assigns Contract B to Company C. Company B transfers the entire cash surrender value directly to Company C. Company C includes the transferred cash surrender value of Contract B in Contract C. A will not receive any of the cash surrender value of Contract B that is transferred to Company C and deposited into Contract C. No other consideration will be paid by A in the transaction. The terms of Contract C are unchanged by the transaction, and Contract B terminates. The IRS ruled that the transaction qualifies as a tax-free exchange under Section 1035.

Service Contracts

The IRS issued two private letter rulings, PLR 200237010 [111] and PLR 200242027 [112], in each case finding that a company that issued extended service contracts was an insurance company for tax purposes. In the rulings, the IRS generally found that the contracts were insurance contracts, not prepaid service contracts. Unlike prepaid service contracts, the contracts were aleatory contracts under which the companies were obligated to indemnify the purchaser for economic loss, not covered by warranties, arising from the

[108] Rev. Rul. 2002-75, 2002-45 I.R.B. 812.

[109] PLR 9708016 (Feb. 21, 1997).

[110] PLR 9644016 (Nov. 1, 1996).

[111] PLR 200237010 (Sep. 13, 2002).

[112] PLR 200242027 (Oct. 18, 2002).

breakdown and repair of a purchased motor vehicle. Further, companies' liability was limited to indemnifying the contractholder for losses, and the companies did not provide any repair services or reimbursement for any preventative maintenance services. By accepting a large number of risks, both companies distributed the risk of loss under the qualifying vehicle protection contracts so as to make the average loss more predictable. These rulings are consistent with prior rulings in this area.

The PLRs may have some applicability under Notice 2002-70, which made certain producer-owned reinsurance companies listed transactions—and specifically identified transactions with automobile dealers. The IRS has been actively pursing abuses in this area.

Waivers Under Section 7702

The IRS released two Private Letter Rulings addressing waivers under Section 7702. Both rulings confirmed the IRS's willingness to waive failure to satisfy Section 7702(a) requirements attributable to reasonable error. The second ruling is different from the majority of waivers under Section 7702 in that it grants a waiver for a misinterpretation of law instead of a mechanical, clerical, or technological error. The ruling may indicate a broadening of the IRS view of what constitutes "reasonable error."

PLR 200219022[113]

Taxpayer had databases in place to determine whether premium payments would exceed the applicable guideline premium limitation. The databases caused the employees to conclude, erroneously, that rejected payments would not exceed the guideline premium limitation, and employees manually overrode the database and posted the payments to the contracts. In fact, however, the posting of these payments to the contracts resulted in the guideline premium limitation being exceeded. The IRS ruled that Taxpayer's failure to meet the requirements of Section 7702(a) was due to reasonable errors and a 90 day waiver under Section 7702(f)(8) was granted.

[113] PLR 200219022 (May 10, 2002).

PLR 200230037[114]

Company A was a stock life insurance company. Company A's Contracts were designed to comply with Section 7702 by satisfying the "guideline premium requirements" of Section 7702(a)(2)(A) and by falling within the "cash value corridor' of Section 7702(d); however, some Contracts did not meet the requirements.

Company A represented that some Contracts violated the requirements of Section 7702 because of an assumption about the relationship between the Tabular Cash Value and the Accumulation Value. Using the legislative history of Section 7702, Company A's actuaries designed the contractual guarantees underlying the Accumulation Value to be insufficient to mature the Contracts. The IRS determined that Company A misinterpreted the legislative history in assuming that the Tabular Cash Value would always exceed the Accumulation Value.

The IRS determined that the failure of contracts to satisfy the requirements of Section 7702 was due to reasonable error and that the errors were a possible misinterpretation of the mechanics of Section 7702 with respect to these types of Contracts.

> ***Businesses in New York, Washington and other large cities are finding it increasingly difficult to obtain workers' compensation insurance for their employees, as insurance companies more closely monitor their accumulation of risk exposure in urban areas. Reinsurance companies, which normally help insurers spread their risks, are for the most part excluding terrorism coverage from their policies. So an insurer that writes a workers' compensation policy for a large company might be able to spread part of the risk using reinsurance, but is still vulnerable to large terrorism losses.***
>
> Christopher Oster, "Workers' Comp Insurers Shy From Businesses in Big Cities," *Wall Street Journal*, July 22, 2002, Page B8.

[114] PLR 200230037 (Jul. 26, 2002).

Capitalized Costs

CCA 200220006[115]

The IRS ruled that Taxpayer's expenditures to develop insurance products were not required to be capitalized under Section 263.

In developing the Type E and F products and prior to placing the products on the market, Taxpayer incurred the following expenses: **(1)** general overhead, **(2)** actuarial services, **(3)** registration, **(4)** legal and professional fees, **(5)** computer expenses, **(6)** promotional expenses, and **(7)** educational/training expenses. On its income tax returns, Taxpayer deducted the full amount of the costs as ordinary and necessary business expenses.

Taxpayer argued that it was entitled to claim a current deduction for the expenses it incurred to establish the products. Taxpayer also argued that it was entitled to deduct these amounts currently, subject only to the capitalization requirements of Section 848. In its ruling, the IRS agreed with Taxpayer that the proxy approach of Section 848 generally trumps the application of Section 263.

> ***Rep. John Conyers (D-MI) has drafted a bill that would create a federal insurance fund for homeowners whose insurance policies don't cover mold claims. And last month, a House subcommittee held a hearing on mold, focusing on scientific research into the problem and the economic impact of mold claims and litigation.***
>
> Christopher Oster, "Insurance Companies Just Say 'No' to Covering Mold"
> *Wall Street Journal*, August 8, 2002, Page D1.

Variable Life Contracts

PLR 200206047[116]

The IRS ruled that certain group annuity contracts satisfy the requirements of Section 817(d)(1)-(3), and thus qualified as "variable contracts."

[115] Chief Counsel Advisory 200220006 (May 17, 2002).

[116] PLR 200206047 (Feb. 8, 2002).

Taxpayer, a life insurance company, issued individual and group annuity contracts based on separate asset accounts ("Account 1" and "Account 2"). Taxpayer intended to issue the Contracts to tax-exempt organizations, such as universities and private foundations.

Accounts 1 and 2 were pooled, open-end, separate accounts to which gains or losses were credited or charged without regard to any other income, gains, or losses of the Taxpayer. A Contract-holder could direct Taxpayer to provide payment of "life," "stated amount," or "stated period" annuities with respect to the amounts held under the Contract.

The IRS found that the Contracts met the requirements for variable contracts in Section 817(d)(1) and the requirements of annuities in Sections 817(d)(2)(A) and 1.72-2(b)(1). The Contracts met the requirements of Sections 72(u)(1)(A) even though the Contracts were not held by natural persons.

Section 1275 Regulations[117]

Final regulations under Section 1275 provide guidance as to whether certain annuity contracts issued by insurance companies are excluded from the definition of a debt instrument under the original issue discount (OID) provisions. The final regulations adopt, without change, proposed regulations published January 12, 2001.

Section 1275(a)(1)(B) excepts annuity contracts from the definition of a debt instrument if Section 72 applies and either **(i)** the contract depends on the life expectancy of 1 or more individuals, or **(ii)** the contract is issued by an insurance company subject to tax under subchapter L or by a Section 501(c) entity. According to the examples, an annuity contract issued by a foreign insurer without a U.S. trade or business or 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.

[117] *See* 67 Fed. Reg. 30547 (May 7, 2002), adding Treas. Reg. § 1.1275-1(k).

Chapter 10

Other Federal Issues

A significant development for property casualty companies was the release of Rev. Proc. 2002-46, which acknowledged a company's right under the matching principles to accelerate certain premium acquisition expenses. It provided insurance companies subject to tax under Section 831 with a safe harbor method of accounting for premium acquisition expenses and, further, provided for automatic consent of the Commissioner in changing to the safe harbor method. Closely related to Rev. Proc. 2002-46 was the release of Rev. Proc. 2002-54 which published guidance on the one-year Section 481 adjustment period. The IRS also released a Field Service Advice ruling related to changes in accounting method.

In *State Farm Mutual Automobile Insurance Co., et al. v. Commissioner*, 119 T.C. No. 21, the Tax Court determined that the AMT book income adjustment for a consolidated life/non-life group must be made using a consolidated approach, with a single adjustment for the entire group. Life/non-life consolidation was also addressed in a coordinated issue paper under the IRS's Industry Specialization Program. As a direct result of legislation passed in 2002, most particularly the March economic stimulus bill, several changes were made to IRS forms and publications. The Job Creation and Worker Assistance Act of 2002 provided a zero rate for both the differential earnings rate and recomputed differential earnings rate beginning in 2001. Appropriate waivers were made for Form 8390. Because the Act extended the NOL carryback period to five years, guidance was issued on Forms 1139 and 1120X.

Policy Acquisition Costs

Rev. Proc. 2002-46[118]

The Revenue Procedure provides a safe harbor method of accounting for premium acquisition expenses, and a procedure to obtain automatic consent to change to the safe harbor method. This long-promised Revenue Procedure was issued in response to the industry outcry over the recent Section 832 regulations which in many cases required the acceleration of premium income without consideration of the related premium acquisition expenses. Many companies filed, and waited for a response to, Form 3115, Application for a Change in Method of Accounting, as a response to the inequity in the regulations. This procedure was the answer.

The Revenue Procedure provides a clearer definition of premium acquisition expenses than the regulations, and also provides definitions of *pro forma premium acquisition expenses* and *pro forma unearned premium reserves*. Taxpayers can deduct as premium acquisition expenses the sum of **(a)** amounts paid, **(b)** the change in unpaids recorded on the NAIC blank, and **(c)** the change in the newly defined *pro forma premium acquisition expenses*. In no case, however, will the pro forma premium acquisition expenses be deductible in excess of the pro forma unearned premium reserve offset amount for the year.

Taxpayers may account for premium acquisition expenses incurred for taxable years beginning after December 31, 1999 by using the safe harbor method described in the Revenue Procedure. The calculation of the safe harbor is complicated, though the IRS gives one clear example of how the calculations should be applied.

Rev. Proc. 2002-54[119]

As an aside, the IRS also issued Rev. Proc. 2002-54, clarifying an earlier revenue procedure regarding the application of the one-year Section 481 adjustment period. Rev. Proc. 2002-54 provides that companies with applications or ruling requests filed under Rev. Proc. 97-27 for a year of change ending

[118] Rev. Proc. 2002-46, 2002-28 I.R.B. 105.

[119] Rev. Proc. 2002-54, 2002-35 I.R.B. 432.

before December 31, 2001, and pending on March 14, 2002, may modify the application to defer the year of change to the first tax year ending after December 30, 2001, and take advantage of the one-year adjustment period.

The Revenue Procedure provides that companies that have received consent agreements may apply the one-year adjustment period under certain circumstances. The Revenue Procedure also allows taxpayers filing applications for a change in accounting method under Rev. Proc. 2002-9 or any predecessor additional time to request the application of a 4-year Section 481(a) adjustment period for net negative Section 481(a) adjustments for taxable years ended on or after December 31, 2001, and on or before April 30, 2002.

Life/Non-Life Consolidations

State Farm Mutual Automobile Insurance Co., et al. v. Commissioner

The State Farm non-life subgroup generated significant losses in 1989 due to claims arising from hurricane Hugo. That loss could not be used to offset life subgroup income and was required to be carried back to 1987. The carryback of this loss resulted in an AMT liability for the group in 1987. Relying on explicit statutory and regulatory language, State Farm determined its AMT book income adjustment (applicable for 1987-1989 only) using a consolidated, single adjustment approach. The IRS disagreed.

The IRS argued that the relationship between the book income adjustment and the ATNOL deduction required that the subgroup method be used to respect the life/non-life loss limitations. The IRS argument was based on the idea that the AMT regime is intended to operate parallel to the regular tax system, which would require the application of the subgroup method.

The court found that State Farm's method of computing the book income adjustment was proper. In its discussion, the court indicated that there was no specific preemption of the explicit language of the book income adjustment, noting that the AMT regulations were promulgated after the life-non-life regulations. According to the court, "no provisions were put in place to specify unique treatment for these insurance entities, although the Commissioner had been made aware of the issue by a comment received after issuance of temporary regulations." The court reasoned that the life-nonlife preemption provisions in the consolidated return regulations had not been augmented and were not intended to apply to provisions other than those for consolidated returns. Furthermore, the court pointed out that the calculation of the book income adjustment preceded the ATNOL deduction. In summary, the court found that there was insufficient statutory or regulatory support to diverge from the consolidated, single adjustment approach required under the AMT rules.

The case helps to clarify the often ambiguous areas associated with the interaction of the life-nonlife rules and the non-insurance specific provisions of the Internal Revenue Code. The court strictly relied on explicit statutory language, dates of regulatory promulgations, and the mechanics of the book income adjustment calculation. This case may support such reliance for similar issues.

**ANNUAL RATE OF RETURN,
PROPERTY/CASUALTY AND LIFE/HEALTH INSURANCE, 1995-2001**

	Property/Casualty Insurance		Life/Health Insurance	
YEAR	SAP ACCOUNTING[1]	GAAP ACCOUNTING[2]	SAP ACCOUNTING[3]	GAAP ACCOUNTING[4]
1995	9.0%	8.7%	12.5%	11.0%
1996	9.5	9.3	12.7	10.0
1997	11.9	11.6	13.4	12.0
1998	9.0	8.5	9.7	11.0
1999	6.7	6.0	11.3	13.0
2000	6.5	5.9	12.8	10.0
2001	-2.3	-1.4	8.6	7.0

[1] Net income after taxes, divided by year-end policy holders' surplus. Calculated by the Insurance Institute from A.M. Best Company, Inc. data.

[2] Return on average net worth, Insurance Services Office, Inc.

[3] Return on equity, A.M. Best Company, Inc.

[4] Combined stock and mutual companies from data reported by Fortune as calculated by the Insurance Information Institute.

Source: A.M. Best Company, Inc.; Insurance Services Office, Inc.

Insurance Information Institute, *The Financial Services Fact Book 2003*, Page 4.

ISP Life/Non-life Consolidation

The IRS released a coordinated issue paper under its Industry Specialization Program, concluding that income and losses of newly acquired nonlife members of a consolidated group cannot be aggregated when determining the amount of nonlife losses which may be used to offset the taxable income of life insurance companies in a life-nonlife consolidated return. The IRS drew on the Tax Court's decision in *CIGNA Corporation v. Commissioner*, 109 T.C. 100 (1997), aff'd, 177 F.3d 136 (3rd Cir. 1999), cert. denied, 120 S.Ct. 496 (1999) in its conclusion.

In *Connecticut General Life Insurance Company v. Commissioner*, 109 T.C. 5 (1997), a consolidated group acquired several groups of affiliated corporations. Each of these acquired groups had filed a consolidated return prior to acquisition. The acquiring group included a life member and had made a valid election to file a life/nonlife consolidated return. During the years under examination, the acquired groups constituted "ineligible" entities because they had not been affiliated with the acquiring life/nonlife group for at least five years. Consequently, any losses of the acquired corporations were not eligible to offset the income of any life members of the group under Section 1502(c)(1) and (2).

The Tax Court questioned whether the acquiring group could net the income and losses of the acquired nonlife subgroups to calculate an aggregated loss or income amount to be subject to the life/nonlife limitations. The taxpayer had applied a subgroup approach to the acquired nonlife members while the IRS advocated separate company treatment.

In this coordinated issue settlement position, the IRS stated that "Appeals Officers should not concede any part of this issue." Further, the IRS stated "Each newly acquired nonlife member's individual loss must be subtracted in its entirety from the nonlife subgroup's net loss before the nonlife subgroup loss may be used to offset the life subgroup's income."

Differential Earnings Rate for 2001

The IRS issued Rev. Rul. 2003-4[120] containing the differential earnings rate for 2001 and the recomputed differential earnings rate for 2000. Tentative determinations of the rates had been published in Notice 2002-19.

The Job Creation and Worker Assistance Act of 2002 amended Section 809 of the Code to provided that the DER will be treated as zero for purposes of computing both the differential earnings amount and the recomputed differential earnings amount for a mutual life insurance company's taxable year beginning in 2001, 2002, or 2003. Accordingly, for purposes of Section 809, the differential earnings rate for 2001 and the recomputed differential earnings rate for 2000 are zero (0). Due to the legislative change, recomputed rates will not be required for 2001 through 2003.

IRS Forms and Publications

Waiver of Requirement to File Form 8390

The Job Creation and Worker Assistance Act of 2002 amended Section 809 to provide that the DER should be treated as zero. As a result, the IRS will not be computing the DER and RDER for 2001, 2002, or 2003. Generally, The DER and RDER are determined by the IRS on the basis of information reported by mutual life insurance companies and the 50 largest stock life insurance companies on Form 8390, *Return for Determination of Life Insurance Rates Under Section 809*.

It is expected that the requirement that companies file Form 8390 will be reinstated in 2004; therefore, all life insurance companies that may be required to report 2001, 2002 or 2003 information should retain the records necessary to report the appropriate information in 2004. Mutual life insurance companies will be required to file a Form 8390 with respect to calendar years 2002 and 2003. Additionally, any stock life insurance company that is determined to be one of the 50 largest stock life insurance companies during 2001, 2002 or 2003 will be required to file a Form 8390 with respect to that year.

[120] Rev. Rul. 2003-4, 2003-1 I.R.B.1.

When filing Form 1120-L for 2001, mutual life insurance companies were required to treat the DER as zero for purposes of computing the differential earnings amount in Schedule C. Appropriate changes will be made to Form 1120-L for 2002.

Forms 1139/1120X

The IRS updated its Internal Revenue Manual (IRM) to articulate procedures for processing applications for tentative refunds on Form 1139 or 1045 resulting from the temporary extension in the 2002 stimulus bill of the general NOL carryback provision to five years.

Under the procedures, if the taxpayer already filed a Form 1139 or Form 1045 for the year in which the loss arose, and the 12-month ending date for filing an application for tentative refund (one year from the end of the year in which the NOL arose) has not expired, the taxpayer should file an amended application on Form 1139 or 1045. If the 12-month period has expired, the taxpayer must file an amended return on Form 1120X or Form 1040X to claim the refund from the NOL carryback.

The IRS released a revised version of Form 720, Quarterly Federal Excise Tax Return with revised instructions. The return for the quarter ending December 31, 2002 is due by January 31, 2003. The instructions noted certain excise tax changes, effective after December 31, 2002, to be reflected on Form 720 for the first quarter of 2003. The changes generally applied to the sale of luxury passenger vehicles, use of international air facilities, and fuel related taxes.

Separate Accounts

TAM 122486-02

The IRS ruled in TAM 122486-02 that the “amount retained” under Treas. Reg. 1.801-8(e)(1) includes all of the contractual charges and fees that Taxpayer subtracts from the separate account, including mortality and expense charges, annual maintenance fees, administrative fees, and premium tax charges. However, contingent deferred sales charges are not included in the “amount retained” because these charges are already reflected in tax reserves.

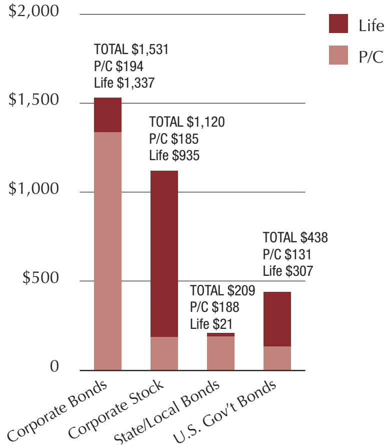
Taxpayer issued variable annuity contracts supported by separate accounts. Taxpayer had no front-end charges relating to its variable annuity contracts, and any premium contributions made by the policyholder were credited without reduction to the separate accounts. Taxpayer imposed a number of charges and fees over the life of the contracts, which reduced the policyholder's available account value. The charges were either non-contingent, recurring fees or contingent, non-recurring fees.

The IRS Field Director disagreed with the manner in which Taxpayer applied the formula under Treas. Reg. 1.801-8(e)(1) to deduct the company's share of intercorporate dividends received by the separate account. Taxpayer and the IRS Field Director disagreed on what contractual charges and fees are included in "any amount retained" for purposes of the reduction to the separate accounts current earnings rate. The Field Director contended that to properly apply the formula, the fees included in "amount retained" should be limited to items which are allocable to the separate account's current investment income.

The IRS noted that if Taxpayer's fees were included in the calculation of required interest, Taxpayer would be treated as having credited a greater amount of investment earnings to policyholders than was actually reflected in Taxpayer's separate account reserves. However, since fees were subtracted from the separate account values underlying the reserves, Taxpayer's deduction for increases in the separate account reserves does not include the fees that Taxpayer charges against the separate account.

On the other hand, contingent deferred sales charges were already reflected in tax reserves and should not be included in the "amount retained." Because Taxpayer must reduce the amounts deducted as an increase in reserves by applicable surrender charges, Taxpayer effectively included these surrender charges in taxable income through its reserve deduction.

INSURANCE INDUSTRY STOCK AND BOND HOLDINGS *(in billions)*



Total Industry Holdings=$3,3 Trillion.

Source: I.I.I. from Federal Reserve Flow of Funds Reports as of December 31, 2001.

Robert P. Hartwig, "What Can Insurers Do to Clean up the Corporate Governance Mess?' *National Underwriter*, June 24, 2002, Page 51.

PLR 200246022[121]

The IRS ruled that amounts received under annuity and life insurance contracts allocated to an account segregated from the general account of Taxpayer (a foreign corporation electing to be treated as a domestic corporation under Section 953(d)) will be treated as amounts segregated from the general account, and therefore variable contracts, for purposes of Section 817(d)(1).

Taxpayer is subject to a Private Act under foreign legislature providing that certain amounts received under life insurance and annuity contracts be allocated to accounts segregated from the general account. Taxpayer issues annuity and life insurance products, whereby the cash surrender value of those products varies with the investment performance of underlying assets allocated to its segregated accounts.

[121] PLR 200246022 (Nov. 15, 2002).

The provisions of Section 953(d), which are intended to tax a foreign company as a domestic company, would be violated under a narrow reading of the term "State" through the avoidance of the Section 817(h) diversification requirements. Accordingly, the IRS applied a broad interpretation of "State" and ruled that the segregation of assets in accordance with the foreign Private Act qualifies as a segregation of assets pursuant to State law or regulation under Section 817(d)(1).

PLR 200244001[122]

The IRS has been looking closely at the issue of investor control. Many separate account products, COLI in particular, have provided a great deal of flexibility to the policyholder. In this case, the structure failed because it was also offered to *non-insurance company investors*.

Insurer intended to offer variable life insurance contracts. The assets supporting the Contracts would be segregated from the assets that support Insurer's traditional life insurance products and Insurer would maintain a Separate Account for the assets. At purchase, the Contract owner would specify the premium allocation among the available sub-accounts and could change this allocation at any time. The only subaccounts available would be a variable money market fund and a number of Private Investment Partnerships ("PIP"), sold in private placement offerings both inside and outside the variable contracts.

Insurer requested a ruling that it would be considered as the owner of interests in PIPs. The IRS concluded that the contract holder, rather than insurer, was the owner of an interest and that the earnings from the interest were includible in the Contract holder's gross income under Section 61(a).

Section 1221 Regulations

The IRS issued[123] final regulations under Section 1221 relating to the character of gain or loss from hedging transactions. The final rules adopt, with modifications, the proposed regulations published January 18, 2001.

[122] PLR 200244001 (Nov. 1, 2002).

[123] 67 Fed. Reg. 12863 (Mar. 20, 2002).

The final regulations were restructured to implement a broader risk management standard in characterizing hedging transactions. Specific provision was made for the recognition of additional types of qualifying risk management transactions through published guidance or private letter rulings. The final rules permit the determination of whether a transaction manages risk to be made on a business unit basis, provided the business unit is within a single entity or consolidated return group that adopts the single-entity approach.

The final regulations contain an example directed at variable annuity COLI contracts. In the example, the regulations conclude that the investment is not made primarily to manage the taxpayer's risk and is not a hedging transaction.

> ***With medical-malpractice insurance premiums skyrocketing in many states, the General Accounting Office has been asked to investigate what role insurance companies had in creating the need for the current rate increases. Ten Democratic members of Congress, led by Rep. John Conyers Jr. (D-MI) sent a letter to the GAO asking the investigative arm of Congress to examine financial statement and other information submitted to regulators by insurance companies that offer medical-malpractice insurance.***
>
> Christopher Oster, "Lawmakers Seek GAO Examination of Insurers' Rates," *Wall Street Journal*, July 3, 2002, Page D3.

Baker v. Commissioner

In *Baker*,[124] the Tax Court ruled that Warren Baker, an insurance agent for State Farm Insurance Company, did not own a capital asset or sell a capital asset to State Farm, nor did the termination payment Baker received represent payment for transfer of a capital asset to State Farm. Further, the Court found that Baker was not entitled to capital gain treatment for the termination payment received from State Farm and must treat the payment as ordinary income.

Baker entered into an agents agreement with State Farm wherein he agreed to write insurance policies exclusively for State Farm. The agreement provid-

[124] *Baker v. Commissioner*, 118 T.C. 452 (2002).

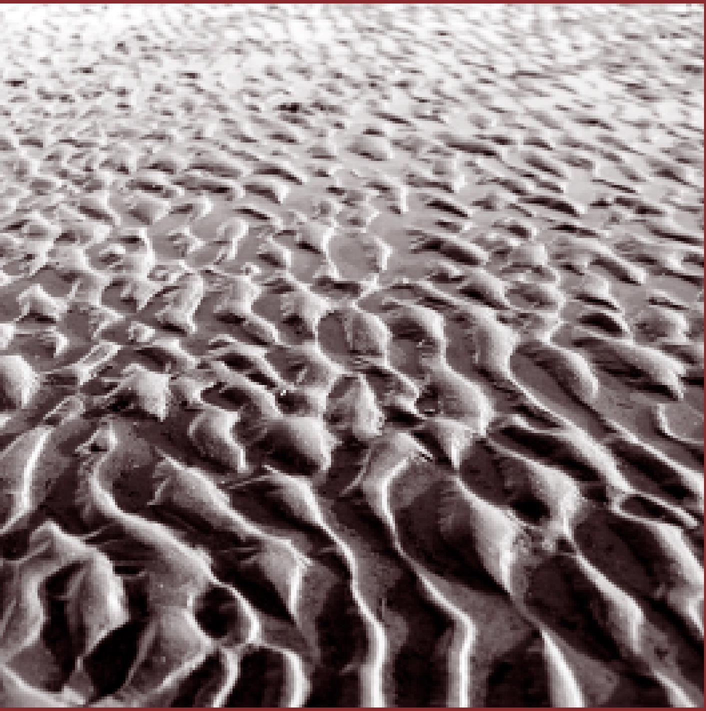
ed that all property including information about policy holders belonged to State Farm. When Baker retired, he returned account information, computers and the like to State Farm and the successor agent. Baker received a payment from State Farm pursuant to the termination agreement.

Baker reported the payment on his income tax return as a long-term capital gain. The IRS disallowed capital gain treatment and determined that the payment was ordinary income (though the IRS did not impose self-employment tax on the income).

Research Credit

In a brief for the Seventh Circuit Court of Appeals, shareholders in Applied Systems Inc. argued that the Tax Court erred in denying the research credit under Section 41 for modifications to computer programs for insurance companies. The Tax Court had previously determined that ASI's reconstruction of the qualifying expenses was insufficient to establish whether the expenses qualified for the research credit. The court also found that employees merely updated the programs and did not invent anything new.

Chapter 11



Multistate

2002 followed in the footsteps of 2001 with many changes in the state and local taxation of insurance companies both through the state legislatures and through the state court systems. Many states attempted to increase their premium tax rates while other states imposed additional assessments or eliminated credits in an attempt to increase the dwindling state coffers.

Some of the more substantive changes at the legislative level include a premium tax rate reduction in Iowa, a change in the annuity tax base in West Virginia, new fire assessments in Kansas and Maine, new workers compensation assessment in Oklahoma and changes from assessment on paid losses to a workers compensation surcharge in Minnesota. In addition, Alabama, Georgia, Kentucky and Iowa passed credits against the premium tax for investments in certified capital companies.

On the judicial and audit side, there were several surprise audit positions while the judicial decisions tended to favor the taxpayer. A settlement marked an end to the protracted litigation in Illinois as a result of Illinois premium tax preference scheme having been found unconstitutional. Maine began to assess annuity taxpayers on the front-end basis. A Minnesota court found that a mutual life insurance company that sells accident and health business is a mutual property and casualty insurer for purposes of the reduced premium tax rate. A New Jersey court determined that life insurers could include New Jersey special purpose assessments on the New Jersey side of the retaliatory tax calculation. Finally, the Texas Supreme Court overturned the lower court decisions and held that internal rollovers are not receipts and thus not subject to the premium tax, and a challenge to the state's "in lieu of" provisions was overturned by a Texas District Court.

State-by-State Developments

Alabama

House Bill No. 627 increases the amount of available venture capital for small technology businesses by using a credit against the premium tax for investments in certified capital companies (CAPCOs). The total amount of certified capital for which premium tax credits may be allowed under this act for all years in which premium tax credits are allowed is $100 million. No premium tax credits can be used until the second calendar year after the year of the investment by the certified investor. A certified investor may take up to 12.5 percent of the vested premium tax credit in any taxable year, once the credits are earned.

Alaska

House Bill No. 246 imposes a late payment fee on title insurance companies of **(i)** $100 a day or 25 percent of the tax due, whichever is greater, from the date the payment was due to the date paid and **(ii)** interest at the rate of one percent a month or part of a month from the date the payment was originally due to the date paid for each day the insurer fails to pay the premium tax in the form required and within the time established.

Arizona

House Bill 2181 creates a premium tax credit from 1/4 to 1/2 of eligible employee salaries, based on length of employment, created in an enterprise zone. There is also a residency requirement for the employee in order to claim the credit. The tax credit is not allowed for the portion of the tax payable to the fire fighters' relief and pension fund or the portion of the tax payable to the public safety personnel retirement system.

Senate Bill 1134 eliminates the premium tax credit for domestic and disability life reinsurers, and requires the Department of Insurance to revise its fee and credit structure.

California

A California parent holding company was not entitled to a deduction on its combined California corporation franchise tax return for interest expense allocable to dividends received from its non-combined California insurance subsidiaries because neither the income nor the apportionment factors of these subsidiaries was included in the parent company's measure of tax.[125] In addition, the disallowance of the deduction was appropriate because exclusion of the dividend income of the California insurance subsidiaries from the parent's measure of tax was not analogous to the exclusion of dividends paid and received among members of a combined unitary group.

Insurers in California writing workers compensation policies with deductibles are subject to premium tax on deductible amounts received from insured employers under a notice issued by the California Department of Insurance. The deductible amounts are classified as gross premiums for tax years 1997 and forward.[126] However on December 18, 2002, the California State Board of Equalization unanimously overruled the Department of Insurance and held that its attempt to collect retroactive premium taxes on amounts reimbursed to insurers from employers under high-deductible workers compensation policies was invalid. Outgoing Insurance Commissioner Harry Low stated that he would urge new Commissioner John Garamendi to appeal the ruling in January, when three of the Board's five members will be replaced.

> ***Insurance industry organizations are predicting turmoil for some sectors of California's commercial insurance market and the general economy after the state's insurance commissioner rejected terrorism exclusion language proposed by the Insurance Services Office, Inc. Regulators in a majority of states have approved the ISO language, which , among other thresholds, provides an exclusion if insured damages from terrorism exceed $25 million.***
>
> Daniel Hays, "New York, California Balk at ISO Terrorism Exclusions," *National Underwriter*, January 14, 2002, Page 5.

[125] California State Board of Equalization, *In the Matter of the Appeal of Fremont General Corporation (Ca. BOE No. 27969)*.

[126] California Department of Insurance, Notice, 2/25/2002.

Florida

The Florida Department of Revenue has ruled that a company acting as an agent for an intangible tax-exempt insurance company with no filing requirement is also exempt from the intangible tax on asset holdings.[127]

Georgia

House Bill No. 1441 provides that any certified investor who makes an investment of certified capital pursuant to an allocation of tax credits shall, in the year of the investment, earn a vested credit against state premium tax liability equal to 100 percent of the certified investor's investment of certified capital. After July 1, 2005, a certified investor can claim up to 10 percent of its vested tax credits in any taxable year to offset its state premium tax liability for the year, plus up to 10 percent of the original amount of any tax credits some or all of which was carried forward from prior years when the 10 percent for that year was not utilized. In the event that the certified investor is unable to utilize the full 10 percent allowable for the taxable year, the remainder may be taken in a future tax year limited to 10% of the amount carried forward.

> ***Gramm-Leach-Bliley promises profound changes in the financial services industry, but it also poses unexpected hazards for taxpayers hoping to take advantage of the new fluidity. State tax schemes with respect to banking, insurance, and securities firms, are all designed for the old world in which such firms operated strictly within their own spheres of influence. Insurance companies, banks, and securities firms looking to form new affiliations could find themselves facing an even more onerous tax burden because the state tax structure has not kept pace with the changes in federal law.***
>
> Russell W. Banigan, "Welcome to the Brave New World of Financial Services: Unexpected State Tax Ramifications of Gramm-Leach-Bliley," *BNA Daily Tax Report*, February 4, 2002 Page J-1.

[127] Florida TAS 02C2-005.

Idaho

The Idaho Supreme Court held that a parent corporation is not entitled to deduct income it received as dividends from one of its insurance company subsidiaries for income tax purposes. The Court found that parent company AIA and its insurance subsidiary Universe Life do not have the same tax liability since Universe Life is required to pay premium taxes instead of income taxes. Therefore, Universe Life could not file a combined report with AIA. The court also stated that AIA was not allowed to deduct the dividends paid to it by Universe Life because not "more than 50% of Universe Life's taxable income for the taxable year immediately preceding the declaration of such dividends was taxable by the state of Idaho."[128]

The Idaho State Tax Commission ruled that statutory provisions that substitute the premium tax for other state taxes imposed on an insurance company do not apply to a licensed corporate insurance agent.[129] The taxpayer, a corporation that was a licensed corporate insurance agent, collected insurance premiums for insurers, which then paid premium tax on the gross premiums and remitted commissions to the taxpayer. The taxpayer claimed a corporate income tax refund for tax years 1998 to 2000, arguing that state law prohibits imposition of income tax on the taxpayer's activities. The commissioner disagreed, contending that Section 41-405(1), which substitutes the premium tax for other state taxes imposed on an insurance company, does not extend to licensed corporate insurance agents.

> ***Investment advisors in the state of Idaho will soon be able to provide clients with fee-based advice on life insurance even if they do not have any kind of life insurance license, according to recently passed Idaho Bill No. 1342. The National Association of Insurance and Financial Advisors opposes the exemption for investment advisors, stating, "It is our view that investment advisors should not be exempted from insurance consulting laws."***
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> Barry Higgins, "Despite Opposition, Idaho Exempts IAs From Insurance Licensing Requirement," *National Underwriter*, April 1, 2002, Page 42.

[128] *AIA Services Corporation v. Idaho State Tax Commission*, 136 Idaho 184, 30 P.3d 962 (2001).

[129] *In the Matter of the Protest of (Taxpayer name withheld from published opinion.), Idaho State Tax Commission*, No. 15375, 11/06/01.

Illinois

Senate Bill No. 2212 allows taxpayers to elect to treat all income as "business income" for income tax purposes. The bill states that for each taxable year beginning on or after January 1, 2003, a taxpayer may elect to treat all income other than compensation as business income. This election shall be made in accordance with rules adopted by the Department and, once made, shall be irrevocable.

The Illinois Appellate Court, Fourth District, upheld the refusal of the Illinois Department of Insurance to refund insurance premium taxes previously found by the Illinois Supreme Court to violate the state constitution's uniformity clause.[130] The decision was reached because taxpayers had failed to pay under protest. In a companion case, the U.S. Supreme Court denied *certiorari in Milwaukee Safeguard*.[131] Settlement was eventually reached between plaintiffs and state of Illinois, thus avoiding long discovery proceedings that would have been aimed at proving whether or not the plaintiffs passed the unconstitutional tax on to policyholders.

Indiana

House Bill No. 1001 increases the Indiana adjusted gross income tax on corporations from 3.4 percent to 8.5 percent, effective January 1, 2003. The Indiana gross income tax, which has been historically imposed on corporate taxpayers to the extent that it exceeded the adjusted gross income tax, will be repealed, effective January 1, 2003. In addition, effective January 1, 2003, the definition of "corporation," for purposes of the adjusted gross income tax, will be amended to include life insurance companies under Section 816(a), as well as insurance companies subject to the tax imposed under Section 831.

[130] *Nationwide General Insurance Company v. Shapo*, 767 N.E.2d 936 (Ill.App. 4 Dist. 2002).

[131] *Milwaukee Safeguard Ins. Co. v. Selcke*, 754 N.E.2d 349 (Ill.App. 1 Dist. 2001), appeal denied, 763 N.E.2d 772 (Ill. 2001), cert. denied, -- U.S. --, 122 S.Ct. 1952 (2002).

> ***Illinois will become the third state to implement guidelines for companies to check if insureds who die and have a claim filed for their insurance contracts had multiple policies in force. The regulation (Title 50 of the Administrative Code, Part 919) was finalized during the week of July 8 and will become effective in July 2003.***
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> Jim Connolly, "Illinois Acts on Multiple Policies," *National Underwriter*, July 22, 2002, Page 3.

Iowa

2001 Iowa House File No. 2035 expands the property rehabilitation credit to allow insurance companies to take advantage of the credit. 2001 House File 2378 amends a tax credit relating to the enterprise zone program by allowing the credit to be used against the premium tax.

2001 Iowa House File No. 2271 creates a venture capital credit for investments in community-based seed capital funds. For tax years beginning on or after January 1, 2002, this tax credit will be allowed against premium taxes for the portion of a taxpayer's equity investment in a community-based seed capital fund. The tax credit will equal 20 percent of the taxpayer's equity investment. The maximum amount of tax credit for an investor in a qualifying business is $50,000. The tax credit may not be redeemed during any tax year prior to January 1, 2005. The tax credit is not transferable to any other taxpayer.

House Study Bill 715 and Senate File 2318 reduce Iowa's gross premium tax rate from two percent to one percent for insurance companies and associations, including mutual health insurance corporations, HMOs, and organized health delivery systems. The reduction is phased in ratably over a four year period beginning in the 2003 calendar year for life and health insurance companies and associations, and beginning in calendar year 2004 for insurance companies and associations other than life and health insurance companies and associations.

The bill also provides that if the previous year's liability is $1,000 or more, then the company must prepay 50 percent of that amount by June 1. The increased amount of prepaid tax liability is phased in over a three-year period. The phase-in schedule for life and health insurance companies and associations imposes an increase of 17 percent of the previous year's liability for the 2004 calendar year, 46 percent for the 2005 calendar year, and 50 percent for the 2006 and subsequent calendar years. For insurance companies and associations other than life and health, the phase-in schedule imposes an increase of 15 percent of the previous year's liability for the 2005 calendar year, 42 percent for the 2006 calendar year, and 50 percent for the 2007 and subsequent calendar years. This additional prepayment amount is due by June 30.

2001 House File No. 2586 creates a venture capital credit for investments in venture capital funds. This tax credit will be allowed against premium taxes for the portion of a taxpayer's equity investment in a venture capital fund. The tax credit will equal six percent of the taxpayer's equity investment, and is limited to $5 million in the aggregate per taxpayer. A taxpayer may not claim the credit until the third tax year following the investment in the venture capital fund.

Kansas

Senate Bill No. 508 imposes a fee upon each fire insurance company doing business in Kansas for purposes of maintaining the emergency medical services board. The fee will be applicable beginning with the year 2003 and will not be more than 0.25 percent of a sum equal to the gross cash receipts as premiums of such company on all fire business transacted by it in Kansas during the next year, as shown by its annual statement to the state insurance department.

House Bill No. 2505 provides that any investor that makes a certified capital investment will earn a refundable tax credit against state tax liability equal to 50 percent of the amount of such investor's certified capital investment. The investor, or a person to whom the credits were duly transferred, will be entitled to claim not more than 10 percent of the credit per taxable year for taxable years commencing on and after January 1, 2005. If the amount of the tax credit allowed exceeds the tax liability of the taxpayer for any taxable year, the excess amount will be refunded to the taxpayer. The total amount of tax credits that may be allowed may not exceed $20 million in the aggregate, or $2 million per fiscal year.

The National Association of Independent Insurers found in the course of a nationwide survey of its state counsels and lobbyists that the ability of insurers to use credit reports for underwriting and rating is a developing controversial issue in about 21 states. While 46 states in 2001 addressed privacy, as required by the Gramm-Leach-Bliley Act, 15 or 16 states will have to engage in some form of "cleanup." This means that regulators in those state will have to either promulgate of clarify rules on the issuance of privacy notices sent by insurers to consumers.

E.E. Mazier, "Insurers Face State Regulatory Hurdles," *National Underwriter*, January 14, 2002, Page 11.

Kentucky

House Bill No. 525 provides that a Life Insurance company investor shall be entitled to a nonrefundable credit equal to 40 percent of the investor's proportional ownership share of all qualified investments made by its investment fund and verified by the Kentucky Development Finance Authority. The aggregate tax credit available to any investor shall not exceed 40 percent of the cash contribution made by the investor to the investment fund. The credit may be applied against the income tax, the corporation license tax, the insurance taxes (i.e., tax on capital of domestic life insurance company, premium tax on life insurance company, and retaliatory tax), and the taxes on financial institutions.

Louisiana

House Bill No. 98 provides that a corporation that owns at least 80 percent of the capital stock of a subsidiary property and casualty insurance corporation is entitled to deduct from its taxable capital the amount of its investments in and advances to the subsidiary insurance corporation that was allocated to Louisiana.

House Bill No. 267 and Senate Bill No. 87 extend the current CAPCO provisions through December 31, 2005. Furthermore, the bills authorize the carryforward of premium tax reduction credits for use in any subsequent year, provided the reduction in any taxable year does not exceed the premium tax liability for that year. Moreover, the bills provide that total insurance premium tax credits in any calendar year may not result in an additional reduction of total premium tax revenues of greater than $7 million per year statewide.

Maine

House Paper No. 1548 sets the maximum workers compensation insurance assessment for years beginning in 2002.The total assessment on all companies may not be more than $6,860,000 beginning in the 2002-2003 fiscal year.

House Paper No. 1704 provides that every fire insurance company or association that does business or collects premiums or assessments in Maine must collect a special assessment from policyholders of insured fire risks located in Maine issued or renewed on after July 1, 2002 and prior to July 1, 2003. The assessment is equal to 0.6 percent of the gross direct premiums for fire risks written in Maine, less the amount of all direct return premiums and all dividends paid to policyholders on direct written premiums. The assessment must be paid on an installment basis at the end of each month starting July 31, 2002 and ending June 30, 2003. Every fire insurance company that pays the special assessment after July 1, 2002 may take a credit against its premium tax equal to the special assessment paid in the same month of the previous year.

Hawaii's Governor signed a measure into law that simplifies the state's premium tax law for captives. Under the new rules, effective immediately, all captive licensees will be subject to a flat 0.25 percent tax on the first $25 million of premiums, 0.15 percent on the next $25 million, and 0.05 percent on the premiums in excess of $50 million.

Caroline McDonald, "Hawaii Gets New Captive Tax, Fee Rules," *National Underwriter*, July 15, 2002, Page 26.

Michigan

Senate Bill No. 490 amends the Single Business Tax Act to exempt from the tax a multiple employer welfare arrangement (MEWA) that provides dental benefits and meets the criteria in Section 7001(h) of the Insurance Code. The exemption would apply to tax years beginning after December 31, 2000.

Minnesota

House File No. 2498 provides for a 100 percent deduction for dividends received from a property and casualty insurer that is a member of an affiliated group under the Internal Revenue Code if either: **(1)** the dividend is eliminated in consolidation under Treas. Reg. 1.1502-14(a); or **(2)** the dividend is deducted under an election under Section 243(b). This provision reinstates the dividend deduction that applied to such insurance company subsidiaries before the repeal of the corporate franchise tax on insurance companies in 2001.

House File No. 3163 and Senate File 2792 repeals the two percent premium tax imposed on the state mutual fund insurance company established under chapter 176A.

Senate File 3136 shifts the basis for assessing insurers for the costs of the Second Injury Fund from paid losses to a surcharge on premium.

The Minnesota Supreme Court ruled that an insurance company qualifies as a mutual property and casualty company under the split-rate tax structure.[132] The Court stated that Minn. Stat. Section 60A.15(1)(e) plainly and unambiguously sets forth a split-rate tax structure that establishes a two percent tax rate on life insurance premiums and a lower rate on premiums for all other coverages for mutual property and casualty companies with certain asset volumes. The court concluded that an insurance company with an asset volume between $5 million and $1.6 billion that sells life insurance and also disability insurance and health and accident insurance, is entitled as a mutual property and casualty company under the split-rate tax structure to

[132] *CUNA Mutual Insurance Society v. Commissioner of Revenue*, 647 N.W.2d 533 (Minn. 2002).

a tax rate of two percent on its life insurance premiums and 1.26 percent on its non-life premiums.

Mississippi

House Bill No. 1379 advances by one month (to June 20 from July 20) the due date for premium receipts report and tax for the period beginning April 1. The report and payment for the months of April and May will be due June 20 beginning in 2003 and the payments for the month of June will continue to be due on July 20.

> ***For 30 years New Jersey has applied political solutions to an economic problem, and the result is that five of the nation's top 10 insurers refuse even to do business there. In 1997-1998 the legislature passed reforms that mandated a 15% reduction in premiums, ostensibly in exchange for new fee schedules that would let insurers control costs. Needless to say, customers got the mandated price cut but insurers never got to implement their schedules.***
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> "New Jersey-stan" *The Wall Street Journal*, April 2, 2002, Page A22.

New Jersey

New Jersey Gov. McGreevey signed into law sweeping changes to the corporate tax statute intended to raise more than $1 billion in additional revenue to fill a gap in the state's 2002-03 fiscal budget. Although insurance companies do not pay any of the taxes affected by the legislation, it is likely that non-insurance affiliates, to the extent taxable in New Jersey, will be adversely affected by this legislation. The most dramatic change is the imposition of an alternative minimum assessment (AMA) measured by New Jersey gross receipts or New Jersey gross profits that would be imposed to the extent the AMA exceeds the corporate business tax in any tax year. In addition, the law expands the reach of the corporate business tax, modifies the computation of taxable income, accelerates the due date for estimated tax payments, grants the director new and expanded powers to adjust income, and makes numerous other changes.

In *Aetna Life*,[133] the New Jersey Tax Court held that a foreign life insurance company may include New Jersey special purpose assessments on the New Jersey side of its retaliatory tax calculation and exclude its home state special purpose assessments.

New York

The Metropolitan Commuter Transportation District (MCTD) tax surcharges imposed under Articles 9, 9-A, 32 and 33 of the Tax Law have been extended for taxable years ending prior to December 31, 2005.

> ***New York, whose insurance department has refused to grant domestic carriers an automatic right to exclude terrorism from their policies in New York, said that reinsurers leaving their primary clients bare on terrorism are "starting to test the patience of the regulatory community" and that it was up to primary insurers to start pushing harder for a reasonable accommodation from reinsurers on terrorism coverage.***
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> Sam Friedman, "N.Y. Challenges Insurers on Terrorism," *National Underwriter*, June 17, 2002, Page 34.

North Carolina

The North Carolina General Assembly voted to extend for one year the state's qualified business venture tax credit, which provides breaks for investments in small and start-up businesses. The credit, which provides investors (including insurance companies) a tax break (to be used against the premium tax) based on investments in certain small and start-up businesses, will expire for investments made on or after January 1, 2003.

Oklahoma

House Bill No. 2752 institutes an assessment of each mutual or interinsurance association stock company, CompSource Oklahoma, or other insurance carrier writing workers compensation insurance in the state. The purpose of the assessment is to create a special designated Worker's Compensation

133 *Aetna Life Ins. Co. vs. Director, Div. of Taxation*, 20 N.J.Tax 87 (March 18, 2002).

Assessment Rebate Fund. The assessment amount shall be based upon gross direct written premiums, normal premiums or actual paid losses of the paying party as applicable during the calendar quarter the assessment is due. The assessment amount shall be determined using a rate equal to the sum of outstanding obligations of the Multiple Injury Trust Fund. The rate for the first two calendar quarters of 2002 equals six percent.

Texas

A Texas district judge has issued a final summary judgment in favor of the Comptroller in a lawsuit by USAA Insurance Co. seeking refunds of approximately $200 million in taxes paid since 1991.[134] USAA contended that until the recent change in the Texas statute, insurers that paid the gross premium tax were exempt from paying other taxes, including the sales and use tax, the motor fuels tax, taxes on the sale, rental, and use of motor vehicles, and the telecommunications infrastructure fund assessment. The Comptroller argued that the gross premium tax is intended to be an occupation tax levied against insurance companies for the right to do business in Texas. The Comptroller also contended that the gross premium tax, like the corporate franchise tax paid by some other businesses, is not meant to be a substitute for all other taxes insurance companies must pay. An appeal has been filed.

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. All American Life and the other insurers paid the assessment under protest and filed suit seeking a refund.[135] The Court of Appeals reversed the judgment of the district court, and rendered judgment 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

[134] *United Services Automobile Association v. Rylander*, Tex. Dist. Ct. No. GN103414 (September 3, 2002), appeal filed, No. 03-02-00747-CV (Tex. App.—Austin).

[135] *All American Life Ins. Co. v. Rylander*, 73 S.W.3d 299 (Tex. App.-Austin 2001, writ denied).

something from an external source. Since during an internal rollover transaction nothing is being brought in from outside, there are no premiums or considerations. On May 9, 2002, the Texas Supreme Court declined to review the case, thus the decision by the Court of Appeals stands.

Utah

The Utah Tax Commission has released Tax Bulletin 1-02 that increases the insurance premium assessment rates on workers' compensation premiums. Effective January 1, 2002, rates are **(1)** 9.75 percent for premiums received by all insurers writing workers' compensation, including premiums from state and local government agencies, and **(2)** 9.50 percent for premiums received by a public agency insurance mutual writing workers' compensation.

The Utah State Tax Commission has released Tax Bulletin 6-02 that explains the 2002 Utah Senate Bill 48, which increases the insurance premium assessment rate paid by a public agency insurance mutual. Effective July 1, 2002, the insurance premium assessment rate on workers' compensation premiums will increase from 9.50 percent to 9.75 percent for premiums received by a public agency insurance mutual writing workers' compensation insurance in this state. The Bulletin explains that Senate Bill provides that a public agency insurance mutual may submit an application to directly pay compensation, as a self-insured employer, on behalf of the members of the public agency mutual. If approved, the public agency insurance shall pay an annual assessment to the Tax Commission in the amount and manner provided in UT Sec. 34A-2-202. Tax Commission Form TC-420, Self-Insurer's Tax Return, shall be used to calculate and pay the assessment.

Vermont

House Bill 208, Ch. 114 provides for a credit against insurance premiums tax (and other taxes) for owners of qualified historic building undergoing substantial rehabilitation equal to **(1)** 10 percent of the qualified rehabilitation expenditures for qualified rehabilitation projects located within a downtown development district or (2) 5 percent for qualified rehabilitation projects located within a village center. Beginning July 1, 2003, the credit limitation amount for both rehabilitation credits is increased from $750,000 to $1 million.

House Bill No. 767 reduces the surcharge rate from 1.1 percent of direct written workers' compensation premium to 0.85 percent for the funding of the Vermont Administration Fund Assessment. The bill also increases the allowed assessment for operational expenses of the Vermont fire service training council from a total not to exceed $250,000 annually to a total not to exceed $400,000 annually. These expenses are paid through assessments against insurers writing various fire coverages.

West Virginia

Senate Bill No. 450 and House Bill No. 4467 amend Section 33-43-6 by adding language that provides that failing to make quarterly payments of at least one-fourth of the total tax paid during the preceding year or eighty percent of the actual tax for the current calendar year constitutes failure or refusal to pay the estimated taxes and subjects the insurer to the penalties provided for in Article 43.

> ***With the adoption of a new model law, state legislatures may be cast in the role of Solomon, determining whether sales of variable contracts should be regulated as securities, insurance contracts, or both. The model developed and adopted by the National Conference of Commissioners on Uniform State Laws, streamlines the Uniform Securities Act. It leaves up to state legislatures to decide whether variable contract sales should fall under the jurisdiction of state securities regulators.***
>
> Jim Connolly, "VA Sales Oversight Decision Left in Hands of State Legislatures," *National Underwriter*, August 12, 2002, Page 3.

Senate Bill No. 647 provides that where a life insurer accepts funds under an agreement to accumulate money for future annuity purchases, the annuities are considered collected and received upon actual receipt, or application of the purchase of the annuities. Earnings credited to money accumulated under the latter alternative are also considered annuity considerations. The above alternative under which an insurer files in either 2001, or the year the insurer enters West Virginia, whichever is later, is considered the insurer's election. Life insurers filing a 2001 return must provide written notice to the commissioner of its election within ninety days of March 9, 2002, the effective date of the enactment. Election changes thereafter must have consent of the insurance commissioner.

Chapter 12

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.

Gross Proceeds Reporting to Attorneys

In May, 2002, Treasury issued re-proposed regulations addressing the information reporting and backup withholding responsibilities of payors who in the course of a trade or business make payments to attorneys.[136] *The new proposed rules are significantly different than the originally proposed regulations*. The delivery rule was eliminated; the term "payor" was defined; a $600 threshold was added; and an exception was added for most payments made in the course of a real estate settlement. However, duplicative reporting is still required in certain situations, and gross proceeds continue to be subject to backup withholding.

The delivery rule required information reporting of payments delivered to a nonpayee attorney, if it was reasonable for the payor to believe that the attorney received the check in connection with legal services. The proposed regulations provide that the reporting obligation would arise only in the case of a payment to an attorney by check, where the attorney is named as a sole, joint, or alternative payee. The proposed regulations define the term payor to mean a person who makes a payment if that person is an obligor on the payment, or the obligor's insurer or guarantor.

The proposed rules clarify that the exception to reporting contained in Section 6045(f)(2)(B) applies only to a payment with respect to which information returns are required under Section 6041(a) or another Code section (e.g., Section 6051) **for the same payee by the same payor**.

The proposed regulations permit payors the option to file either one Form 1099-MISC aggregating the annual payments to each payee, or separate forms for each payment. They also retain the payee-recipient rule that requires that the information return be filed with respect to the attorney who receives the check (provided that attorney is a payee on the check).

The regulations will apply to payments made during the first calendar year that begins at least two months after the regulations, once finalized, are published in final form in the Federal Register.

[136] REG-126024-01, 67 Fed.Reg. 35064-35070 (17 May 2002).

Cancellations of Debt

Historically, Section 6050P has required certain financial entities (primarily banks) to file information returns (Form 1099-C) with respect to any discharges of indebtedness of $600 or more. In 1999, Section 6050P was modified to require any organization a significant trade or business of which is the lending of money to report cancellations of debt effective for discharges occurring after December 31, 1999. However, in Notices 2000-19[137] and 2001-8,[138] the IRS has announced that penalties would not be imposed on such organizations that fail to issue Forms 1099-C in connection with any discharge of indebtedness occurring prior to the first calendar year beginning at least two months after the date that appropriate guidance is issued. In June, 2002, the IRS issued proposed regulations that, when finalized will represent such guidance.[139]

The proposed regulations provide guidance on when a trade or business is engaged in the lending of money and when that trade or business is considered significant. Generally, an entity will not be required to report under Section 6050P if, for each of the three most recent test years, its gross income from lending money is less than both 10 percent of the organization's gross income and $3 million.

In addition, the proposed regulations provide a general exception to information reporting for entities whose principal trade or business is the sale of nonfinancial goods or the provision of nonfinancial services. However, under the regulations, an organization that buys and holds loans is treated as an organization that lends money. Lending money includes acquiring a loan; gross income arising from that loan is considered to constitute gross income derived from the lending of money.

Reasonable Cause Procedures for Forms 1099-R

Newly revised IRS Publication 1586 provides the reasonable cause procedures applicable for missing and/or incorrect TINs reported on

[137] Notice 2000-19, 2000-13 I.R.B. 845.

[138] Notice 2001-8, 2001-4 I.R.B. 374.

[139] REG-107524-00, 67 Fed.Reg. 40629-40632 (13 Jun 2002).

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).

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.

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.

NOTE ***that backup withholding rates for 2003 may change if Congress passes an Economic Stimulus Bill in 2003.***

Electronic Payee Statements

A provision in the Job Creation and Worker Assistance Act of 2002 allows payors to furnish Forms 1098 and 1099 electronically. The provision is effective for 2002 forms to be furnished in January, 2003. The provision requires that recipients consent to electronic receipt of information returns in a manner similar to that permitted under existing Section 6051 regulations, which allow employers to furnish Forms W-2 to their employees electronically.

The Section 6051 regulations[140] anticipate the use of a website based technology for delivery. 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 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.

While the change applies to most Forms 1098 and 1099, it does not apply to Forms 1042-S, Schedules K-1, or Forms 1099-R and 5498 that report contributions and distributions of pensions, traditional IRAs, Coverdell ESAs, Roth IRAs, and Archer MSAs.

[140] REG-107186-00, 66 Fed.Reg. 10191-10196 (14 Feb 2001).

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 during 2003. Under the program, payors will be able to submit TINs and corresponding payee names for matching against 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. This program should reduce the number of "B" notices and penalty notices the IRS issues to payors.

TIN matching requests will be able to be submitted via the Internet in two ways: an interactive session scheduled for implementation in February/ March, 2003, and via a bulk transfer scheduled for implementation in May/June 2003. The interactive sessions will be on-line, and limited to 25 requests per session. Results should be provided within 5 seconds. Bulk requests must be submitted electronically and will be limited to 100,000 requests per batch. Results will be provided within 24 hours to an electronic mailbox address.

Payors wishing to participate in the program should contact **sharon.y.wilson@irs.gov.**

Final Middleman Regulations

On July 25, 2002 Treasury finalized regulations under Section 6041,[141] known as the "middleman regulations." The 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

[141] 67 Fed.Reg. 48754-48760 (26 Jul 2002).

from a health insurance company is made for services rendered to joint payees (e.g., a doctor and the 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, must report the payment under Section 6041. A significant economic interest in a payment is an economic interest that would be compromised if the payment were not made. For example, 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 withholding on its behalf by following the procedures set forth in Rev. Proc. 84-33, 1994-1 C.B. 502.

The regulations require the reporting of gross, not net, payments.

The final regulations are effective January 1, 2003, and the changes generally apply for payments or sales made after December 31, 2002.

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

Best Life Assurance Co. of California v. Commissioner, 281 F 3d 828 (9th Cir. 2002). The Appeals Court held that the term "unpaid losses" in Section 816(c)(2) as understood in the life insurance industry, includes only unaccrued unpaid losses.

In re CM Holdings, Inc., Camelot Music, Inc., G.M.G. Advertising and Grapevine Records and Tapes, Inc. Internal Revenue Service v. CM Holdings, Inc. 2002-2 USTC ¶50,596 (Aug. 16, 2002) The Third Circuit Court of Appeals affirmed the decision of the District Court, concluding that Camelot Music's COLI program was a sham in fact and that the program as a whole lacked economic substance.

Capital Blue Cross and Subsidiaries v. Commissioner of Internal Revenue, No. 13322-01 (13 Nov 2001) Capital Blue Cross filed a petition in the Tax Court for a redetermination of a 1994 notice of deficiency.

Edgar L. Parker, et ux. v. Commissioner, T.C. Memo 2002-305. The Tax Court ruled that payments from insurance companies to a district manager as a result of the termination of his contract constituted ordinary income subject to self-employment tax.

Equitable Life Assurance Society of the Untied States v. United States, S.C. N.Y., No. 00 Civ. 4066 (RMB), 2/6/02. The District Court held that the tax benefit rule does not serve to exclude from income certain decreases in life insurance reserves that are otherwise required to be included as income.

GE Life and Annuity Co. v. United States, 89 A.F.T.R. 2d 2002-1815 (E.D. Va. Mar. 25, 2002) a U.S. District Court modified a previous judgment on the request of both parties. The Court granted GE Life and Annuity Assurance Company's Motion for Partial Summary judgment, but denied the United States' Motion for Summary Judgment.

Globe Life and Accident Insurance Company v. United States, 54 Fed. Cl. 132 (2002), October 9, 2002 The Court of Federal Claims found that Globe was not entitled to amortization deductions claimed because it failed to provide an accurate estimate of the useful life of its "agency force."

Minnesota Lawyers Mutual Insurance Company and Subsidiaries v. Commissioner of Internal Revenue, 285 F. 3d 1086 (8th Cir. 2002). The Appeals Court for the Eighth Circuit affirmed the Tax Court ruling and found that Minnesota Mutual's unpaid loss reserve estimates were not "fair and reasonable."

Orin F. Farnsworth and Mary L. Farnsworth v. Commissioner of Internal Revenue, T.C. Memo 2002-29 (January 28, 2002). The Court held that the taxpayers are not entitled to exclude from income any portion of the District Manager's Appointment Agreement (DMAA) contract value termination payments because the taxpayer had no basis in the DMAA contract. Further, the Court held that the termination payments are subject to self-employment tax under Section 1401.

Principal Mutual Life Insurance Company and Subsidiaries v. United States, 295 F. 3d 1241 (Fed. Cir. 2002). The U.S. Court of Appeals for the Federal Circuit ruled that an insurance company must include excess interest guaranteed beyond the end of the tax year in its statutory reserves.

State Farm Mutual Automobile Insurance Co., et al. v. Commissioner, 119 T.C. No. 21. The Tax Court determined that the AMT book income adjustment for a consolidated life/non-life group must be made using a consolidated approach, with single adjustment for the entire group.

Travelers Insurance Company v. United States, 303 F.3d 1373 (Sept. 16, 2002). The Federal Circuit Court of Appeals ruled against Travelers Insurance Company, holding that the policyholders' share of income should have been excluded from LICTI for purposes of foreign tax credit calculation and that Travelers' method of translating foreign currency failed to clearly reflect income.

Trigon Insurance Company (Formerly Blue Cross and Blue Shield of Virginia) v. United States of America, 2002-2 USTC ¶ 50,580 (Aug. 09, 2002). The U.S. District Court for the Eastern District of Virginia ruled that Trigon cannot deduct carryover losses from cancelled subscription and provider contracts because it did not meet its burden of proof when valuing the contract.

Warren L. Baker, Jr. and Dorris J. Baker v. Commissioner of Internal Revenue, 118 T.C. No. 28 (29 May 2002). The Tax Court found that the petitioners were not entitled to capital gain treatment for the termination payment received from State Farm Insurance Company and must treat the payment as ordinary income.

Winn-Dixie Stores Inc. v. Commissioner, U.S., No. 01-1-3-, cert. Denied, 4/15/02. The U.S. Supreme Court denied certiorari for an 11th Circuit Court decision which held that loans that Winn-Dixie took against whole life insurance policies it purchased on the lies of 36,000 full-time employees were substantive shams.

IRS Rulings/Procedures/Notices/FSAs

Revenue Ruling 2002-6 The IRS determined that a change in the computation of existing lie insurance reserves to take into account specific factors set forth in AG 33 is a change in basis subject to Section 807(f).

Revenue Ruling 2002-11 The IRS released a list of the presidentially declared disaster areas for 2001.

Revenue Ruling 2002-75 The IRS described a situation where the transfer of an entire annuity contract into another pre-existing annuity contract qualifies as a tax-free exchange under Section 1035.

Revenue Ruling 2002-89 The IRS addressed whether amounts paid by a domestic parent corporation to its wholly owned insurance subsidiary were deductible as “insurance premiums” under Section 162.

Revenue Ruling 2002-90 The IRS considered whether amounts paid for professional liability coverage by domestic operating subsidiaries to an insurance subsidiary of a common parent were deductible as “insurance premiums” under Section 162.

Revenue Ruling 2002-91 The IRS ruled on whether a "group captive" formed by a group of unrelated businesses involved in a highly concentrated industry to provide insurance coverage is an insurance company under Section 831.

Revenue Ruling 2003-4 The Ruling contains the differential earnings rate for 2001 and the recomputed differential earnings rate for 2000.

Revenue Procedure 2002-42 The document provides procedures by which an issuer may remedy an inadvertent non-egregious failure to company with the modified endowment contract rules under Section 7702A.

Revenue Procedure 2002-46 The procedure provides insurance companies with a safe harbor method of accounting for premium acquisition expenses and provides for automatic consent in changing to the safe harbor method.

Revenue Procedure 2002-54 The procedure clarifies Rev. Proc. 2002-19 regarding the application of the one-year Section 481 adjustment period.

Revenue Procedure 2002-58 The procedure provides guidance on the domestic asset/liability percentages and domestic investment yields needed by foreign insurance companies and foreign property and liability insurance companies to compute their minimum effectively connected net investment income.

Revenue Procedure 2002-67 The IRS announced a limited settlement program for taxpayers engaging in contingent liability tax shelter transactions.

Revenue Procedure 2002-74 The IRS announced that for purposes of loss reserve discounting under Section 846 and salvage discounting under Section 832, it will issue composite discount factors for accident years not generally disclosed on the annual statement.

Revenue Procedure 2002-75 The IRS also issued Rev. Proc. 2002-75, announcing it will consider ruling requests related to captive insurance arrangements.

Notice 2002-8 The IRS revoked an earlier notice, 2001-10, which provided interim guidance regarding the tax treatment of parties entering into split-dollar life insurance arrangements.

Notice 2002-19 The Notice published a tentative determination under Section 809 of the differential earnings rate for 2001 and the rate that is used to calculate the recomputed differential earnings amount for 2000.

Notice 2002-59 The IRS explained the standard for valuing current life insurance protection under a split-dollar arrangement, including guidance on arrangements where parties attempt to avoid taxes by understating the value of policy benefits.

Notice 2002-69 The IRS provided interim guidance on determining the interest rates and appropriate foreign loss payment patterns to be used by controlled foreign corporations in calculating their qualified insurance income under Section 954(i).

Notice 2002-70 The IRS identified as listed transactions certain reinsurance arrangements used by taxpayers to shift income to related companies purported to be insurance companies that are subject to little or no U.S. federal income tax.

FSA 200202002 The IRS determined that additional development is warranted before conclusions concerning deductions can be reached. The underlying issued of the FSA is whether the contracts between Insurance Subsidiary and other members of Grandparent's group of affiliated companies are insurance contracts for the purposed of federal income tax.

FSA 200202028 The IRS concluded that loans on corporate-owned life insurance (COLI) contracts purchased before June 20, 1986 are not aggregated with debt after that date for determining whether the $50,000 limit of former Section 264(a)(4) has been exceeded.

FSA 200203016 The IRS found that an insurer must change its method of accounting for its payments to and from an experience account which is part of a reinsurance contract.

FSA 200209017 The IRS recommend further factual development to determine whether a retroactive insurance agreement is insurance for tax purposes.

FSA 200210010 The IRS concluded that the taxpayer did not fail the 4 of 7 exception under Section 264(d)(1) where no premiums were paid after the end of the third policy year.

FSA 200215002 The IRS ruled that a parent corporation must increase its basis in a subsidiary's stock under Treas. Reg. 1.1502-32 by the amount of the subsidiary's "Fresh Start" adjustment.

FSA 200236003 The IRS concluded that amounts claimed by Taxpayer and disputed by Insurance Company on proofs of loss are not includible in Taxpayer's gross income until the litigation between the parties is settled and the additional amount to be received is determinable.

FSA 200238032 The IRS ruled that distributions made by Sub to Parent are consideration paid to purchase Parent's stock in Sub.

Announcement 2002-63 The IRS announced that it will request workpapers relating to the tax reserve for deferred tax liabilities and to footnotes disclosing contingent tax liabilities appearing on audited financial statements.

Announcement 2002-96 The IRS announced that it will end the settlement initiative for broad-based leveraged COLI plans purchased after June 20, 1986.

Announcement 2002-97 The IRS announced that it will offer limited settlements to taxpayers with basis shifting tax shelter transactions.

2002-2003 Priority Guidance Plan. The Treasury and the IRS released a guidance plan that lists guidance projects expected to be completed over a 12 month period, from July 2002 through June 2003.

Quarterly Update to IRS Priority Guidance Plan. The IRS issued the first quarterly update to the IRS "business plan" for the year ending June 30, 2003. Many of the additional projects related to employee benefits, exempt organizations, general tax, and tax administration.

Private Letter Rulings and Technical Advice

PLR 200201004 The IRS ruled that the merger of a Blue Cross/Blue Shield insurer with another insurance company is not a material change in operation or structure under Section 833(c)(2).

PLR 20020647 The IRS ruled that certain group annuity contracts satisfy the requirements of Section 817(d)(1)-(3) to qualify as "variable contracts."

PLR 200208017 The IRS ruled that a mutual life insurance company's conversion to a stock corporation holding structure will be a tax-free recapitalization under Section 386(a)(1)(E).

PLR 200210065 The IRS ruled that transactions as part of the liquidation of an insolvent insurance company will not be annual additions under Section 415 or cause a loan to the company's ESOP to fail.

PLR 200210024 The IRS ruled that the income from a multi-employer insurance program that reimburses medical expenses is excludable from gross income under Section 115.

PLR 200213001 The IRS ruled that a mutual life insurance company's conversion to a stock corporation holding structure will be a tax-free recapitalization under Section 386(a)(1)(E).

PLR 200213002 The IRS ruled that a mutual life insurance company's conversion to a stock corporation holding structure will be a tax-free recapitalization under Section 386(a)(1)(E).

PLR 200213003 The IRS ruled that a mutual life insurance company's conversion to a stock corporation holding structure will be a tax-free recapitalization under Section 386(a)(1)(E).

PLR 200219002 The IRS ruled that the payment of demutualization proceeds by Trust to Taxpayer will not result in Taxpayer incurring an excise tax pursuant to Code Section 4976(b)(1)(C).

PLR 200219022 The IRS concluded that Taxpayer's failure to meet the requirements of Section 7702(a) were due to reasonable errors and that a 90 day waiver under Section 7702(f)(8) would be granted.

PLR 200230037 The IRS granted a waiver under Section 7702(f)(8) for the failure of life insurance policies for misinterpretation of a law.

PLR 200237010 The IRS ruled that a company that issues extended service contracts is an insurance company for tax purposes.

PLR 200240051 The IRS ruled that the conversion of a mutual insurance company into a stock company qualifies under Section 368.

PLR 200242005 The IRS ruled that Taxpayer is a mutual insurance company that is a reciprocal underwriter within the meaning of Section 832(f).

PLR 200242027 The IRS ruled that extended service contracts are insurance contracts and that Taxpayer qualifies as an insurance company under Section 831.

PLR 200244001 The IRS ruled that the contract holder, rather than insurer, is the owner of an interest held as a sub-account underlying a variable life contract, and that the earnings from the interest are includible in the Contract holder's gross income under Section 61(a).

PLR 200246022 Amounts received under annuity and life insurance contracts allocated to an account segregated from the general account of Taxpayer, in accordance with foreign law, will be treated as amounts segregated from the general account "pursuant to state law or regulation," and therefore variable contracts, for purposes of Section 817(d)(1).

TAM 200210028 The IRS concluded that Taxpayer is not entitled to relief under Section 7805(b) from the retroactive application of the TAM requiring taxpayer to determine its effectively connected income under the standards set forth in Section 864(c).

TAM 200213010 The IRS ruled that Taxpayer purchased its COLI programs pursuant to a plan that lacked economic substance and business purpose.

TAM 122486-02 The IRS determined that the "amount retained" includes all of the contractual charges and fees that Taxpayer subtracts from the separate account, including mortality and expense charges, annual maintenance fees, administrative fees, and premium tax charges.

ILM 200220006 The IRS ruled that Taxpayer's expenditures to develop insurance products should not be capitalized under Section 263.

Regulations

Section 61, 83, 301, 1402, and 7872 Regulations The IRS released proposed regulations on the taxation of split-dollar life insurance arrangements. The regulations provide two mutually exclusive regimes for axing split-dollar life insurance arrangements – the economic benefit regime and the loan regime.

Section 337 and 1502 Regulations The regulations set forth ruled governing a consolidated group's allowable loss or basis reduction on a disposition or deconsolidation of subsidiary stock.

Section 338 Regulations The IRS released proposed regulations reflect the IRS position that the proper model to be utilized in the acquisition of an insurance business is that of an assumption reinsurance transaction. The Regulations include the impact on Sections 197, 381, 846, 847, and 1060.

Section 419A Regulations The IRS issued proposed regulations regarding the exception from the generally applicable deduction limits on contributions to single-employer welfare benefit funds for welfare benefit funds sponsored by 10 or more employers under Section 419A(f)(6).

Section 702 Regulations Final regulations under Section 702 and Subpart F clarify the treatment of a controlled foreign corporation's distributive share of partnership income under Subpart F.

Section 807, 811, 812, and 817A Regulations The regulations define the appropriate interest rate to be used in the determination of tax reserves and required interest for certain modified guaranteed contracts.

Section 1221 Regulations The IRS issued final regulations under Section 1221 relating to the character of gain or loss from hedging transactions.

Section 1275 Regulations The IRS issued final regulations under Section 1275 providing guidance as to whether certain annuity contracts issued by insurance companies are excluded from the definition of a debt instrument under the original issue discount provisions.

Section 4371 Regulations The IRS issued final regulations on liability for the insurance premium excise tax on insurance issued by a foreign insurer under Section 4371.

Section 6011, 6111, 6112 Regulations The regulations modify the rules on reporting and registering tax shelters.

Section 6041 Regulations The IRS released final regulations under Section 6041 that provide information reporting requirements for escrow agents and other persons making payments on behalf of another person, clarify who is the payee for information reporting purposes, and clarify the amount to be reported.

Section 6043 Regulations The regulations require information reporting by a corporation if control of the corporation is acquired, or if the corporation has a recapitalization or other substantial change in capital structure.

Section 6050P Regulations The proposed regulations provide guidance on when a trade or business is engaged in the lending of money and when that trade or business is considered significant.

Section 6051 Regulations The regulations anticipate the use of a website based technology for electronic delivery of Forms 1098 and 1099. They also allow employers to furnish Forms W-2 to their employees electronically.

Appendix B

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Your worlds Our people