Continuing Developments in the Taxation of Insurance Companies

2005 | The Year in Review*

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Forward

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

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

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Washington National Tax Services
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Table of Contents

Table of Contents

chapter 1

The Year in Review

Storms

2005 was defined by natural disaster and catastrophe. On January 1, 2005, the world was still responding to the tsunami which struck on December 26, 2004, killing an estimated 216,000 in eleven countries[1]. Following the tsunami, were two major earthquakes and three category 4 hurricanes. The disasters permanently changed the lives of those involved, and had an immeasurable effect on economies, industries, and national and local identities. As the world watched these disasters unfold, charitable giving reached record levels.

Impact on Economy

In a year full of disaster and uncertainty, the news could have been worse for the U.S. economy. However, the New York Times reported that "By almost all measures, [2005] was a good one for the American economy. The economy expanded by about 3.6 percent in 2005, the fourth consecutive year of solid growth, despite the soaring energy prices and the destruction caused by Hurricane Katrina. Consumer prices climbed at a rate of 3.5 percent for the 12 months ended in November, but only about 2 percent after excluding the volatile sectors of food and energy."[2] Additionally, the government said the economy grew at an annual rate of 4.3% in the third quarter of 2005; and, though forecasters warn the current quarter won't be as strong, their outlook for coming months is upbeat[3].

All this was very good news considering the anticipated insurance premium rate boosts and a spike in oil prices, which many expected would slow the rate of growth for the U.S. economy. "Some insurers have told energy companies as far from the… storms' Gulf Coast strike zone as the U.K. that their annual premiums could increase 20% to 50%, as the insurance industry tries to recoup losses estimated at as much as $60 billion for Katrina alone. Moody's Investors Service, Inc. said it expected

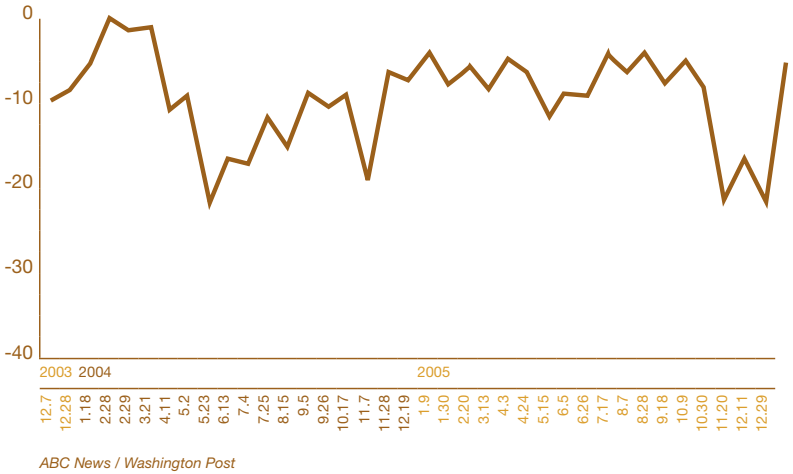
1. "Tsunami's Death Toll Still Unclear," Associated Press Newswire, December 1, 2005.
2. Edmund L. Andrews and Richard W. Stevenson, "Bush Cites 2 Million New Jobs in 2005 and Healthy Economy," The New York Times, January 7, 2006, page 1.
3. John D. McKinnon and Rafael Gerena-Morales, "As Economy Builds Up Strength, White House Seeks More Credit," The Wall Street Journal, December 3, 2005, page A1.

corporate insurance rates to return to 2003 levels, after two years of declines."[4]

Although the Consumer Comfort Index dropped during the fall, in the wakes of three hurricanes, it rose again, despite expectations that oil, construction materials, and insurance prices would surge.

Consumer Comfort Index

The Consumer Comfort Index uses a scale of +100 to -100 and is based on responses to questions about the national economy, personal finances, and the buying climate.



ABC News / Washington Post

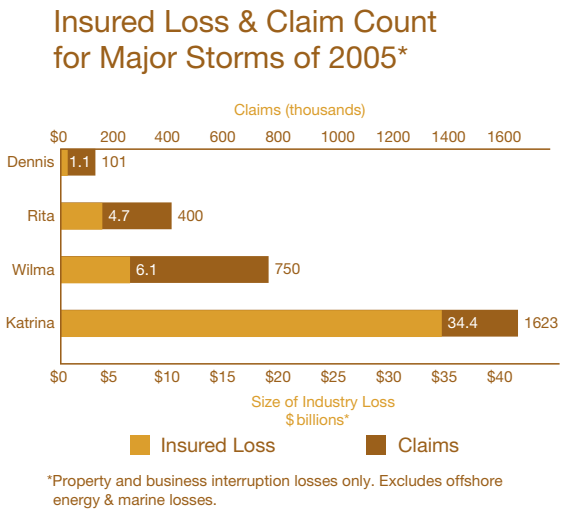
Source: "National Barometer: Major Political Trends," PollingReport.com, http://www.pollingreport.com/national.htm#Bush, January 16, 2006.

Insurance Industry

The permanent effect that seven major hurricanes in 2004 and 2005 will have on the insurance industry is still unknown. According to A.M. Best, "Third-quarter 2005 catastrophe losses were the costliest ever on record, and the effects are showing up across the insurance industry."[5] Property and casualty insurers are reported to have paid "a record $80 billion in homeowners and business losses in 14 states in the quarter." The previous worst third quarter had $23.7 billion in losses[6]. The Insurance

4. Charles Fleming, "Moving the Market – Tracking the Numbers/Outside Audit: Insurance Buyers Seek to Sidestep Rate Boost," The Wall Street Journal, September 26, 2005, Page C3.
5. "Effects of Costliest Catastrophe Quarter Felt Across Industy," Bestwire Service, November 8, 2005, as reported by AdvisenFPN.
6. Ibid.

Services Office estimated that Katrina could reach as much as $60 billion in insured losses[7]. Losses related to Hurricane Rita were estimated at $4.7 billion, and losses related to Hurricane Dennis were estimated at $1.1 billion[8]. Munich Re Foundation put 2005's financial losses at more than $200 billion, and insurance claims at more than $70 billion[9].



Source: Robert P. Hartwig, "Hurricane Season of 2005: Impacts on US P/C Insurance Markets in 2006 & Beyond," Insurance Information Institute, http://www.iii.org/media/presentations/katrina, December 7, 2005.

In September, with estimates of losses growing, rating agencies put property and casualty insurance providers on notice that they could be due for a storm-related downgrade. Moody, Standard & Poor's, and Fitch Ratings put negative ratings watches on insurers like Allstate, State Farm, PXRE Group Ltd., Allmerica, Swiss Re, and United Fire and Casualty, among others[10].

While downgrades certainly were not good news, despite extraordinary hurricane damage, property and casualty impairments for 2005 were expected to be the lowest in a decade. An A.M. Best special report found, "Typically, major

7. Ibid.
8. Ibid.
9. "The Worst Weather Ever? At $200bn, it's Certainly the Costliest," The Independent, December 7, 2005, as reported in AdvisenFPN.
10. Daniel Hays and Caroline McDonald, "Downgrades Loom as Katrina Loss Grows," National Underwriter Property & Casualty-Risk & Benefits Management Edition, September 19, 2005.

catastrophes trigger surges in P/C impairments, pushing already vulnerable companies into financial failure… [H]istory does not seem to be repeating this time, thanks to particular financial and underwriting strength seen recently in the industry."[11]

The report continued, "Coinciding with improving operating results, P/C insurers' financial impairments have shown a sharp downtrend in 2003-2005, with the failure rate in 2004 falling to the lowest level since 1996, and known 2005 impairments annualizing to an impairment rate even lower than in 2004, one that would tie 1996 for the lowest impairment rate since 1980. The final number for 2005, however, may well be higher or lower, but it is not likely to be significantly worse than the 2004 results."[12]

While the insurance industry at large weathered the hurricanes well, Business Insurance reported that, "Shaken by record hurricane losses, some property insurers and reinsurers [have taken] steps to reduce their catastrophe exposures… by ceasing to write new business—until confidence in profitability for those risks is restored."[13] As it becomes more difficult to obtain insurance against hurricane damage, businesses may be forced to self-insurer, re-locate, or go without insurance altogether.

Damage caused by Hurricanes Katrina and Rita sparked a debate on the definition of "flood damage," which is generally not covered by homeowners' policies, and "hurricane damage," which is generally covered. New Orleans Mayor Ray Nagin said that "25 percent of the property damage in the New Orleans area will not be covered by private insurance. After Katrina swamped 80 percent of the city, many residents were surprised to find that the damage to their houses was not covered by standard homeowners' policies, which generally exclude flood damage."[14] Insurance companies refused to pay for flood damage that is specifically excluded by homeowners' policies. Politicians and lawyers anxious to enter the fray took steps to remedy the plight of homeowners. Plans to require insurance companies

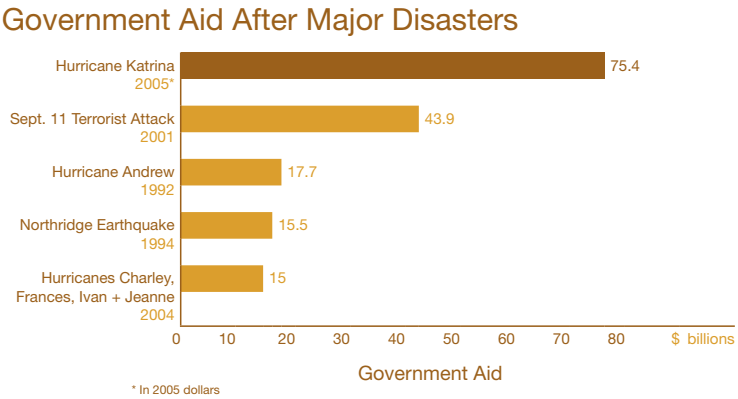
11. "A.M. Best Special Report: P/C Impairments Hit Near-Term Lows Despite Surging Hurricane Activity," Bestwire, December 15, 2005.
12. Ibid.
13. "Insurers Curb Capacity as Storm Losses Mount," Business Insurance, October 21, 2005.
14. "Katrina Sparks Debates about Flood Insurance," The Post-Standard, November 1, 2005, as reported in Advisen FPN.

to cover flood damage or to have U.S. taxpayers foot the bill by retroactively applying the National Flood Insurance program were put forth. The Mississippi Attorney General sued insurance companies to force them to pay and a Mississippi trial lawyer filed a lawsuit on behalf of Gulf Coast residents. In the U.S. House of Representatives, a representative from Mississippi filed a bill to compensate uninsured homeowners by allowing them to buy into the National Flood Insurance program retroactively[15].

Legislation

In the wake of Hurricanes Katrina, Rita, and Wilma, major oil companies were reporting record profits. As the U.S. Congress considered several measures to give aid to hurricane-damaged areas and citizens, Senators Olympia Snowe and Byron Dorgan introduced a windfall profits tax on oil companies. The tax was introduced as an amendment to S. 2020, Tax Relief Act of 2005, but Senators failed to reach the three-fifths majority needed to impose the tax. About $2.9 billion in receipts from the tax would have been earmarked to increase federal expenditures for the Low Income Home Energy Assistance Program which helps the poor pay heating and cooling bills[16]. Many saw the tax as a way to make oil companies accountable for the sharp increase in gasoline prices following hurricane Katrina. Highs of $4 in the immediate aftermath of Hurricane Katrina, when the Gulf region's refining capacity was temporarily knocked out, could have devastated consumers and businesses, had they remained at that level.

15. Ibid.
16. "For the Record," The Washington Post, November 24, 2005, page T13.



Source: Robert P. Hartwig, "Hurricane Season of 2005: Impacts on US P/C Insurance Markets in 2006 & Beyond," Insurance Information Institute, http://www.iii.org/media/presentations/katrina, December 7, 2005.

Although the windfalls profit tax did not pass, two other bills to aid hurricane victims did pass. The Katrina Emergency Tax Relief Act of 2005[17] and the Gulf Opportunity Zone Act of 2005[18] both extend benefits to residents and businesses in the Gulf Coast region.

In September Congress approved $62 billion to cover immediate relief and recovery costs and a $6.1 billion tax relief package, The Katrina Emergency Tax Relief Act of 2005. The Tax Relief Act contained provisions to create tax-favored withdrawals from retirement plans for relief relating to Hurricane Katrina, establish a work opportunity tax credit for Hurricane Katrina employees, create certain charitable giving incentives, and exclude certain cancellations of indebtedness by reason of Hurricane Katrina. President Bush signed the Tax Relief Act on September 23.

In December 2005, Congress passed, and President Bush signed, the Gulf Opportunity Zone Act. The Act provides certain tax benefits for the Gulf Opportunity Zone; extends the bonus depreciation placed–in–service date for taxpayers affected by

17. Pub. L. 109-73.
18. Gulf Opportunity Zone Act of 2005, PL 109-135, December 21, 2005.

Hurricanes Katrina, Rita, and Wilma; offers housing relief for individuals affected by Katrina; and provides various other relief provisions.

In January 2006, the IRS released Publication 4492, Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma. The new publication highlights changes to the tax law and relief provisions available to those affected by the hurricanes. It also lists the applicable disaster areas for each hurricane and explains which areas are eligible for IRS administrative relief and for special tax breaks under recently enacted provisions.

Some expressed the opinion that New Orleans should not be rebuilt; however, President Bush, in his first visit to the city, promised to "do whatever it takes" to rebuild New Orleans and to take "bold action" to confront poverty in the devastated regions. In December the White House "blessed a $3.1 billion plan to upgrade the New Orleans levee system beyond a pre-Katrina level of protection, a move local officials say should spur redevelopment of a city that remains largely a ghost town more than three months after the hurricane."[19] Despite Federal, state, and private funds, conditions are likely to remain the same for quite some time. Many have pointed to a lack of a clear leader in the redevelopment. From New Orleans' Mayor Nagin's rebuilding commission to Donald E. Powell, President Bush's pick to oversee Gulf Coast hurricane recovery efforts, and Louisiana Governor Kathleen Babineaux Blanco's rebuilding commission, some fear that too much involvement from too many parties may keep anything from being accomplished quickly.

Charitable giving

One author called the outpouring of charitable donations a "tsunami of aid dollars."[20] "In the weeks and months that followed the tsunami, American citizens dug deep into their wallets, donating some $1.78 billion to the relief effort in Asia. Since October 2005,

19. Christopher Cooper and Ann Carrns, "Upgrade of Levees In New Orleans Is Backed by Bush," The Wall Street Journal, December 16, 2005, page A11.
20. "Hot Topic: Sweet Charity," The Wall Street Journal, December 24, 2005, page A8.

Americans also contributed $78 million to assist the casualties of the Pakistan earthquake."[21] The Center for Philanthropy at Indiana University estimated that the total value of private donations in response to Hurricanes Katrina and Rita reached $3.12 billion, a record for a single disaster and recovery effort."[22]

> The American Red Cross, facing criticism for its Hurricane Katrina relief effort, said yesterday that its chief executive, Marsha J. Evans, has resigned -- the latest in a string of leaders who have struggled to guide the giant, often troubled charity.
>
> Those who follow the organization say that, whatever the reason for Evans's abrupt departure, it is not good news for the charity, which has stumbled during some of the country's biggest disasters. From the way it distributes money to victims to its treatment of minorities and its handling of blood donations, the organization is facing scrutiny from Capitol Hill, civil rights groups, federal agencies and others.
>
> Source: Jacqueline L. Salmon, "Red Cross Top Official Steps Down; Charity Says Departure Is Unrelated to Katrina," The Washington Post, 14 December 2005, page A01.

Bush

When George Herbert Walker Bush won re-election in November of 2004, he promised Social Security reform, progress in the war on terrorism, and a healthier economy. Few would argue that these promises were largely unrealized as the number of U.S. casualties in Iraq topped 2,000, support for Social Security reform failed to materialized, damage from hurricanes caused gas prices and insurance premiums to spike, several blue chip companies reported failed pension plans, and criticism mounted under the response to Hurricane Katrina and scandals involving Republican political icons.

21. Ibid.
22. Center for Philanthropy at Indiana University, http://www.philanthropy.iupui.edu/Hurricane_Katrina.html, January 11, 2006.

Scandal

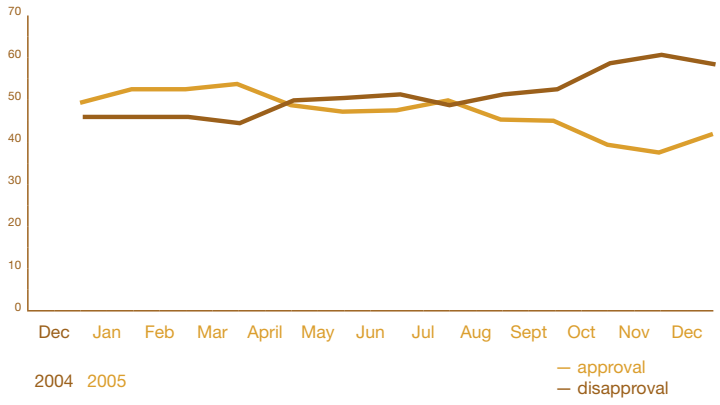
Perhaps the most damaging to Bush's approval rating during the year were the seemingly constant assaults on those surrounding him. Bush's reputation as a straight-shooter has long been considered one of his most positive traits. However, during 2005 that credibility suffered as Vice President Cheney's former chief of staff plead guilty to leaking a CIA agent's name, Texas Republican heavy-weight Tom DeLay was indicted for money laundering, and lobbyist Jack Abramoff was tied to several Republican Members of Congress. DeLay resigned his position as House Majority Leader and cast himself as victim of a "partisan fanatic" bent on avenging Democrats' defeats in a tough Texas redistricting battle,[23] but his indictment added to President Bush's growing list of scandalous associates.

President Bush's Job Approval Rating dropped to its lowest point during the latter end of 2005.

National Barometer on Major Political Trends

President Bush

Do you approve or disapprove of the way George W. Bush is handling his job as president?



Source: "National Barometer: Major Political Trends," PollingReport.com,http://pollingreport.com/national.htm#Bush, January 16, 2006.

23. "Tom DeLay's Fall, Republicans' Fear," The New York Times, January 10, 2006, page 24.

The situation grew worse when DeLay's former aid Michael Scanlon plead guilty to working with lobbyist Jack Abramoff to bilk his Indian casino clients. Abramoff plead guilty to federal corruption charges on January 3, 2006. He was generally known for his dealings with Republicans. The New York Times opined, "With scandal swirling around Tom DeLay and several other Republican congressmen now that the lobbyist Jack Abramoff has pleaded guilty to serious charges and promised to divulge secrets of wrongdoing, the House Majority Leader has become a symbol of ethical decline in the Republican-dominated Congress."[24]

In November 2005, The Washington Post reported "For the first time in his presidency a majority of Americans question the integrity of President Bush, and growing doubts about his leadership have left him with record negative ratings on the economy, Iraq and even the war on terrorism… On almost every key measure of presidential character and performance, the survey found that Bush has never been less popular with the American people. Currently 39 percent approve of the job he is doing as president, while 60 percent disapprove of his performance in office. . . Virtually the only possible bright spot for Bush in the survey was generally favorable, if not quite enthusiastic, early reaction to his latest Supreme Court nominee, Samuel A. Alito Jr. Half of Americans say Alito should be confirmed by the Senate."

Source: Richard Morin and Dan Balz, "Bush's Popularity Reaches New Low; 58 Percent in Poll Question His Integrity," The Washington Post, November 4, 2005, page A01.

24. "Tom DeLay's Fall, Republicans' Fear," The New York Times, January 10, 2006, page 24.

War on Terrorism

In the week after U.S. deaths in Iraq passed the 2,000 mark, the Washington Post reported that 55 percent of respondents to a Washington Post-ABC News poll said the United States is "not making significant progress toward stabilizing the country."[25] The Post continued, "the war has taken a toll on the administration's credibility: Fifty-five percent of those polled now say the administration deliberately misled the country in making its case for war with Iraq—a conflict that an even larger majority say is not worth the cost."[26]

President Bush's handling of terrorism was widely regarded as the reason that he won a second term. "But questions about Bush's effectiveness on other fronts have also depreciated this asset. His 48 percent approval now compares with 61 percent approval on this issue at the time of his second inauguration, down from a 2004 high of 66 percent."[27]

Economy

In January 2006, reacting to charges from fellow Republicans that he had squandered an opportunity to re-create political capital, President Bush began a tour of the nation, touting the strength of the economy, and arguing that the credit belonged largely to his Administration. Despite evidence that the economy was growing steadily at year-end, Bush continued to get negative marks on his handling of economic issues. In a November Wall Street Journal/NBC News poll, just 34% of respondents approved of Mr. Bush's handling of the economy, down from 47% in January 2005.[28] "To ordinary Americans, positive headlines on the economy have been accompanied by sluggish growth in inflation-adjusted wages, energy prices still above last year's levels, rising health-care costs, predictions that the era of rising house prices is ending and warnings about the security of their retirement benefits."[29] So, although the unemployment dropped to 4.9 percent, and the

25. Richard Morin and Dan Balz, "Bush's Popularity Reaches New Low; 58 Percent in Poll Question His Integrity," The Washington Post, November 4, 2005, page A01.
26. Ibid.
27. Ibid.
28. John D. McKinnon and Rafael Gerena-Morales, "As Economy Builds Up Strength, White House Seeks More Credit," The Wall Street Journal, December 3, 2005, page A1
29. Ibid.

economy has soundly beaten growth estimates for the last quarters of the year, the jury remains out on the Bush economic record.

The S&P 500 index gained steadily all year.

Source: New York Stock Exchange, http://www.nyse.com/about/listed/lcdata.html?ticker=SPXl&fq=D&ezd=1Yindex=5, January 16, 2006

Pension Plan Problems

The U.S. Government could be on its way to becoming a big shareholder in the nation's airline industry and possibly the auto industry. When US Airways Group Inc. filed for bankruptcy, The Pension Benefit Guaranty Corp., the federal agency that partially guarantees pensions, received US Airways stock as compensation for the underfunded pension plans it assumed[30]. The Wall Street Journal reported that "The agency is likely to get an even larger stake -- between 15% and 35% of new shares -- of UAL Corp.'s United Airlines when it emerges from Chapter 11 in February [2006]. And it's likely to get sizable chunks of Northwest Airlines, Delta Air Lines and Delphi Corp. -- if, as expected, the companies ask the bankruptcy courts to dump their pension plans on the insurer."[31]

Airlines weren't the only industry seeking government aid for underfunded pensions. In October when auto-parts supplier Delphi Corp. announced bankruptcy, its chairman and CEO stated that Delphi was considering asking the Federal Government to take over its pension obligations, which were underfunded by

30. Michael Schroeder, "Big Stakes in Ailing Airlines Raise Questions for U.S. Pension Agency," The Wall Street Journal, November 3, 2005, Page A1.
31. Michael Schroeder, "Big Stakes in Ailing Airlines Raise Questions for U.S. Pension Agency," The Wall Street Journal, November 3, 2005, Page A1.

as much as $4.3 billion.[32] Delphi was General Motors largest supplier, and GM, which had pension troubles of its own, took the news especially hard. In November General Motors announced that it would restate financial results for 2001 and possibly subsequent years because it overstated 2001 earnings by as much as $300 million to $400 million by "erroneously" booking credits from suppliers[33]. In December Standard & Poor's slashed GM's credit rating and warned that CEO Wagoner's restructuring plan might not be enough to turn the auto maker around.[34]

Social Security and Tax Reform

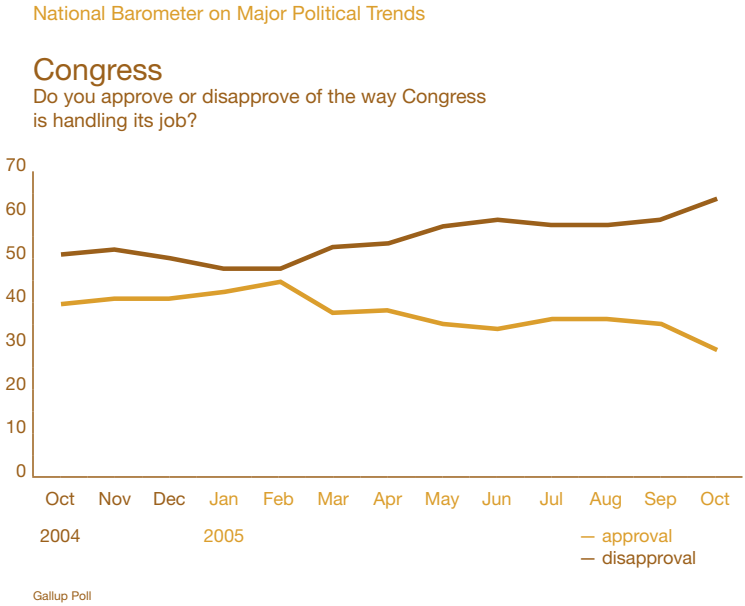
As we go to press, it is apparent that President Bush's push for Social Security Reform is dead. In late spring, President Bush effectively gave up hope for pushing through a sweeping overhaul of Social Security, which he identified as the first of his two major domestic goals when he was re-elected in 2004. "Tax overhaul was the second big goal, and the President had laid out a broad but vague vision to make the income tax simpler, fairer and more conducive to economic growth."[35]

The President's Advisory Panel on Federal Tax Reform, which worked with Treasury staff for months, finalized its two alternatives to the tax code in November of 2005. One streamlines the current income tax; the other would replace it with a progressive tax on consumption. Although it does not seem that either option is likely to be enacted, the proposals raised concerns among life insurers. A panel suggestion to tax the inside buildup of life and annuity policies resulted in an immediate industry outcry. But, with Bush's political capital so low, it is unlikely that he could push through any tax changes of a significant nature.

32. Jeffrey McCracken and John D. Stoll, "Delphi CEO Sees Major Downsizing in Bankruptcy -- - Company Hasn't Decided On Federal Pension Bailout; GM Faces Financial Risks," The Wall Street Journal, October 10, 2005, page A1.
33. Frank McGuire, Michael Lucas and Gregory J. Corcoran, "Year-End Review of Markets & Finance 2005 --- Iraq Elections, Hurricanes & The Supreme Court," The Wall Street Journal, January 3, 2006, page R13.
34. Frank McGuire, Michael Lucas and Gregory J. Corcoran, "Year-End Review of Markets & Finance 2005 --- Iraq Elections, Hurricanes & The Supreme Court," The Wall Street Journal, January 3, 2006, page R13.
35. Edmund L. Andrews, "Bush Expected To Postpone Tax Overhaul Until 2007," The New York Times, December 5, 2005, page 3.

In early December, Bush Administration officials "essentially confirmed reports in Time magazine and The Wall Street Journal that Mr. Bush would not put tax overhaul at the top of his agenda for [2006]."[36]

The public's approval of Congress dropped steadily all year.



Source: "National Barometer: Major Political Trends," PollingReport.com, http://pollingreport.com/national.htm#Bush, January 16, 2006.

36. Ibid.

Legislation

Members of Congress could agree on nothing substantial in 2005, and the only legislation to come out of the session was extensions of previous bills and the afore-mentioned Katrina relief acts, which included technical corrections to various provisions of the American Jobs Creation Act of 2004.

Patriot Act Extension

The highest-profile extension was the renewal of the Patriot Act for one month. Congress voted to extend the Act until March 10, 2006 amid "a bitter political dispute over its reach."[37] The Act provides the Federal Government with "broad power to monitor and prosecute terrorism suspects and those helping them."[38] The Patriot Act is expected to dominate the debate when Congress returns at the end of January 2006 and may "serve as a backdrop for a broader, and possibly even more contentious, argument over Bush's anti-terrorism policies."[39]

Terrorism Risk Insurance Extension Act

The Senate and House passed the Terrorism Risk Insurance Extension Act of 2005, which signed by President Bush on December 22, 2005. The final bill increases the amount of property and casualty losses that trigger Federal payments from $5 million to $50 million in 2006 and $100 million in 2007. It also raises industry deductibles and co-payments and increases the financial stake of insurers. Under the extension, the amount the insurance industry must pay in a year, increased from $15 billion to $25 billion in 2006 and $27.5 billion in 2007.

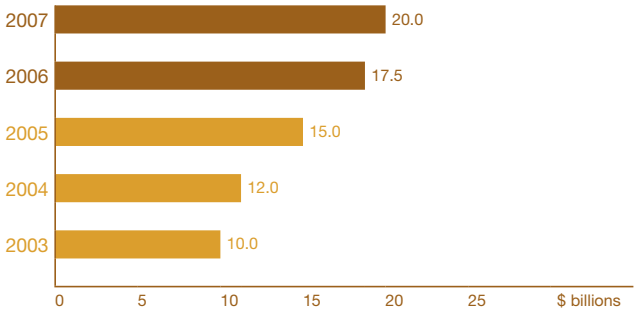
Tax Legislation

In addition to the Patriot Act extension, both houses of Congress passed tax bills and pension bills; however, neither bill went to conference. When the first session of the 109th Congress ended,

37. Jim VandeHei, "Bush Assails Democrats Over Patriot Act; Opponents Are Blocking Law's Full Renewal for Political Reasons, President Says," The Washington Post, January 4, 2006, A02.
38. Ibid.
39. Ibid.

House and Senate Members left town without completing action on a tax reconciliation bill reducing taxes by at least $70 billion over five years.

Insurance Industry Retention Under TRIA



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Source: Robert P. Hartwig, "Hurricane Season of 2005: Impacts on US P/C Insurance Markets in 2006 & Beyond," Insurance Information Institute, http://www.iii.org/media/presentations/katrina, December 7, 2005.

It is expected that Congress will seek to complete action on tax reconciliation legislation early in 2006 and could provide a retroactive extension of 2005 expiring provisions such as research credit, the Work Opportunity Tax Credit, individual AMT relief, and a number of other business and individual tax provisions which expired on December 31, 2005.

Both the House and Senate passed separate versions of tax reconciliation bills (H.R. 4297; S. 2020), but were not able to begin the conference committee process necessary to reconcile the two bills. Action on a tax reconciliation conference could be delayed until February 2006 at a minimum when both the House and Senate will be in session. Further complicating the schedule for finishing 2005 legislation is the fact that Congress also will have to begin work on next year's budget in February.

The key disagreement between the House and Senate tax bills remains the question of how to accommodate all the pending expiring tax provisions within the $70 billion ceiling for net tax reductions provided in the current budget resolution. Both bills would extend many of the same expiring provisions; the main difference is that the House bill would extend capital gains and dividend rates expiring in 2008 at a cost of $20 billion over five years, while the Senate bill would extend individual AMT relief expiring this year at a cost of $30.5 billion over five years. The House did pass individual AMT relief as a separate bill (H.R. 4096) above the amount established for the tax reconciliation bill, but the Senate so far has not agreed to consider individual AMT outside the tax reconciliation process.

Other key tax reconciliation issues remaining open for action in 2006 include consideration of Senate revenue provisions estimated to raise $18 billion over five years. The list of Senate revenue raisers include proposals to codify the economic substance doctrine, disallow deductibility of certain settlement payments and punitive damages, and change tax rules for employee personal use of corporate aircraft. The House bill does not include any revenue raisers.

A tax reconciliation conference in 2006 will need to consider a large number of miscellaneous provisions in the House and Senate bills. Examples of such provisions include differing House and Senate proposals to modify the Section 355 active trade or business test and House provisions to extend the Subpart F active financing income exception (set to expire in 2006) and modify rules for look-through treatment of payments between related controlled foreign corporations.

Pension Reform Legislation

Congress also will need to complete work on pension reform legislation in 2006. The House passed a broad pension reform bill (H.R. 2830), but a conference committee will have to reconcile the

House bill with a Senate-passed pension bill (S. 1783). Issues to be resolved include defined benefit funding rates, the treatment of cash-balance hybrid plans, and defined contribution plan limits.

A Look Ahead

As we look ahead to the new year, many questions remain. The year 2005 was burdened with disaster of many tenors. As the industry continues to recover from the storms of 2005, indications are that the 2006 hurricane season, could be more severe. Experts anticipate that the probability of a major hurricane making landfall in 2006 could be as high as 81 percent, compared to 52 percent in an average year[40]. Other disasters are not so easily predicted – tsunamis, earthquakes, tornadoes, flooding. Equally unpredictable are the incidence of scandal, business failure, new legislation, no legislation, and politics, and their impact on the industry.

	Average*	2005**	2006F
Named Storms	9.6	26	17
Named Storm Days	49.1	115.5	85
Hurricanes	5.9	14	9
Hurricane Days	24.5	47.5	45
Intense Hurricanes	2.3	7	5
Intense Hurricane Days	2.3	7	5
Net Tropical Cyclone Activity	100%	263%	195%

* Average over the period 1950-2000.

** As of December 4, 2005

Source: Robert P. Hartwig, "Hurricane Season of 2005: Impacts on US P/C Insurance Markets in 2006 & Beyond," Insurance Information Institute, http://www.iii.org/media/presentations/katrina, December 7, 2005.

40. Robert P. Hartwig, "Hurricane Season of 2005: Impacts on the US P/C Insurance Markets in 2006 & Beyond," The Insurance Information Institute, December 7, 2005.

chapter 2

Legislation

Although President Bush promised Social Security reform in his re-election platform and spent the early part of the year promoting it, Social Security reform was barely addressed outside of Sunday morning news shows. Instead, following a year which both began and ended with natural disaster, the most significant bills to pass were the Katrina Emergency Tax Relief Act of 2005[41], the Gulf Opportunity Zone Act of 2005[42], highway reauthorization legislation[43], and comprehensive energy legislation[44].

As in years past, insurance-specific legislation was introduced, but quickly shelved. The one insurance-specific bill to be enacted was the extension of the Terrorism Risk Insurance Act of 2002[45], which President Bush signed on December 22, 2005.

Bills introduced but not acted on included a bill to exclude a portion of annuity payments from income, a bill to impose excise tax on amounts received under certain insurance policies, a bill to prevent dividends received from certain corporations from receiving a reduced tax rate, the COLI Best Practices Act, and the annual attempt to permit the consolidation of life insurance companies with other companies.

Enacted Legislation

The Terrorism Risk Insurance Extension Act of 2005 – S. 467 and H.R. 1153

The Senate and House passed separate extensions of the Terrorism Risk Insurance Act of 2002, which were then reconciled and sent to President Bush for signature. Under the original act, insurers were required to offer terrorism insurance to businesses. In return, the government limited the industry's losses in the case of attacks by foreign terrorists, covering 90% of claims stemming from terrorist attacks, after the industry pays $15 billion in damages. The White House pushed for a provision that scales back Federal guarantees with the objective of eventually ending government participation in the terrorism insurance market.

41. Pub. Law 109-73.
42. Gulf Opportunity Zone Act of 2005, P.L. 109-135, December 21, 2005.
43. "Safe, Accountable, Flexible and Efficient Transportation Equity Act: A Legacy for Users, Pub. Law 109-59.
44. Pub. Law 109-58.
45. Terrorism Risk Insurance Extension Act of 2005, P.L. 109-144, December 22, 2005.

The final bill increases the amount of property and casualty losses that trigger Federal payments from $5 million to $50 million in 2006 and $100 million in 2007. It also raises industry deductibles and co-payments and increases the financial stake of insurers. Under the extension, the amount the insurance industry must pay in a year, increased from $15 billion to $25 billion in 2006 and $27.5 billion in 2007.

The reconciliation bill was signed into law by President Bush on December 22, 2005.

The Gulf Opportunity Zone Act of 2005 – H.R. 4440

President Bush signed into law The Gulf Opportunity Zone Act of 2005 (H.R. 4440 or Act) to help individuals and businesses recover from storm damage in the Gulf Coast region. Key provisions of the new legislation include creation of special economic Gulf Opportunity (GO) Zones, enactment of a 50 percent bonus depreciation related to rebuilding, expansion of Section 179 expensing, allowing a five-year NOL carryback for investments, enhancing low-income housing and rehabilitation credits, and increasing the New Markets tax credits. The law also included technical corrections for ten tax laws, including amendments related to the American Jobs Creation Act of 2004[46] (JOBS Act) and clarified provisions of the JOBS Act relating to penalties for reportable and listed transactions. The cost was estimated to be $8.6 billion.

Insurers should assess the impact of the Act on their 2005 tax returns, as well as determine whether any of the tax incentives provide viable opportunities for them in 2006 and later years.

46. American Jobs Creation Act of 2004, Pub. L. 108-357.

Noteworthy Legislation Not Enacted

Tax Relief Extension Reconciliation Act of 2005 – H.R. 4297 and Tax Relief Act of 2005 - S. 2020

Both the House of Representatives and the Senate passed tax relief bills during the latter part of the year. The two versions of tax relief legislation will have to be reconciled in conference. It is expected that Congress will seek to complete action on tax reconciliation legislation early in 2006 and could provide a retroactive extension of 2005 expiring provisions. The table below compares some of the major provisions of the two bills.

Provision	H.R. 4297	S. 2020
Revenue Estimate (FY2006-2010)		
Revenue Estimate (FY2006-2010)	Tax Relief: $56.1 billion Revenue Offsets: $ 0 Net Tax Relief: $56.1 billion	Tax Relief: $76.6 billion Revenue Offsets: $18.8 billion Net Tax Relief: $57.8 billion
Tax Extenders		
Research Credit	Extends research credit.	Same provision
Subpart F Active Financing Income	Extends the exception under Subpart F for active financing income for two years.	No Provision

Provision	H.R. 4297	S. 2020
Revenue Offsets		
Codification of Economic Substance	No provision	Provides that the doctrine, where determined applicable, is satisfied only if (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction, and the transaction is a reasonable means of accomplishing such purpose; • Imposes 40% penalty for understatements of noneconomic substance transactions; and • Disallows deduction for interest on underpayments.
Fines and Penalties	No provision	Disallows deductions for certain settlement payments.
Punitive Damages	No provision	Disallows deductions for punitive damages.
Corporate Inversions	No provision	Modifies 2004 Jobs Act provision on corporate inversions by -- • Applying inversion regime to transactions completed after March 20, 2002 (rather than March 4, 2003); • Lowering present-law 60 percent ownership threshold for former shareholders of U.S. corporation to more than 50 percent; • Increasing the accuracy-related penalties and tightening the earnings stripping rules; and • Excluding transactions involving nonpublicly traded U.S. corporations from the inversion regime.

Pension Reform Bill – H.R. 2830 and S. 1783

After the Bush Administration issued its proposal for strengthening the annual funding requirements for pension plans, separate reform bills were introduced in the House and Senate. The House passed a broad pension reform bill (H.R. 2830), but a conference committee will have to reconcile the House bill with a Senate-passed pension bill (S. 1783).

Both bills would strengthen single- and multi-employer defined benefit pension plans; provide rules applicable to cash balance and other hybrid plans; and increase Pension Benefit Guaranty Corporation premiums. The Senate bill also includes pension funding relief for airlines. The Ways and Means bill includes provisions to encourage automatic 401(k) enrollment; allow rollover of up to $500 of unused flexible spending arrangement balances each year; and make permanent the IRA and pension reform provisions enacted as part of the 2001 Tax Act.

Issues to be resolved in conference include defined benefit funding rates, the treatment of cash-balance hybrid plans, and defined contribution plan limits.

The Retirement Security for Life Act of 2005 – S. 381

Senator Gordon Smith (R, OR) introduced S. 381, The Retirement Security for Life Act of 2005. The bill would have amended the Internal Revenue Code to encourage guaranteed lifetime income payments from annuities by excluding a portion of the payments from income.

The bill provided that for lifetime annuity payments, a taxpayer may exclude from gross income 50 percent of the portion of lifetime annuity payments otherwise includible in gross income under Section 72(b)[47]. The amount excludible in any year would be limited to $20,000, indexed for inflation.

47. All references are to the Internal Revenue Code of 1986, unless otherwise indicated.

In the case of a contract in force on the date of the enactment that does not satisfy the requirements of the bill, the bill provided that any modification to the contract that is made to satisfy the requirements of the bill would not result in the recognition of any gain or loss, any amount being included in gross income, or any addition to tax that otherwise might result from such modification.

Two companion bills, H.R. 819 and H.R. 2951, were introduced in the House of Representatives by Rep. Nancy Johnson (R, CT) and Earl Pomeroy (D, ND). None of the bills came to a vote during the legislative session.

Bill to impose excise tax on amounts received under certain insurance policies - S. 993

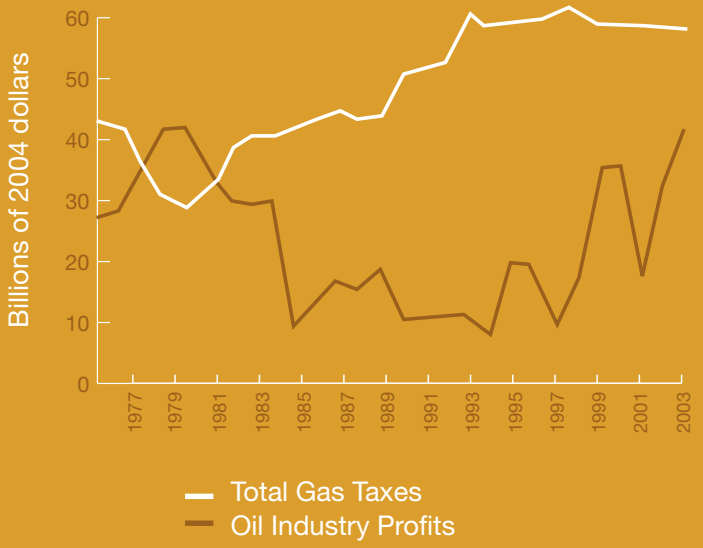
Senate Finance Committee Chairman Charles Grassley (R, IA) and Ranking Member Max Baucus (D, MT) proposed legislation to impose an excise tax on amounts received under certain insurance policies in which certain exempt organizations hold an interest.

The bill would have amended Section 42, relating to excise taxes involving private foundations and certain other tax-exempt organizations, by adding Subchapter F, which would impose a 100 percent excise tax on the acquisition costs of "any life insurance, annuity, or endowment contract with respect to which both an applicable exempt organization and a person other than an applicable exempt organization have directly or indirectly held an interest in the contract (whether or not at the same time)."

The bill was an attempt to get at disparate transactions whereby tax benefits are generated for one party without creating an offsetting taxable income impact on another taxpayer. The legislative proposal was included in the Pension Reform Act[48], which is expected to come to a vote in 2006.

48. H.R. 2830 and S. 1783.

Following Hurricane Katrina, when prices spiked as demand outpaced supply, there was some talk in Congress about assessing oil companies with a "windfall profits tax." Shortly thereafter, The Tax Foundation published the results of a study comparing oil company profits with Federal and state gasoline taxes:



Source: Scott A. Hodge and Jonathan Williams, "State and Federal Treasuries 'Profit' More from Gasoline Sales than U.S. Oil Industry," The Tax Foundation, October 26, 2005.

COLI Best Practices Act of 2005 – H.R. 2251

House Ways and Means Committee Member Thomas Reynolds (R, NY) introduced H.R. 2251, the COLI Best Practices Act of 2005. The bill would have revised the current law and would have limited the amount of the proceeds from company-owned life insurance (COLI) which could be excluded from taxable income.

In the case of an employer-owned life insurance contract, the bill provided that the amount excluded from the gross income of the employer shall not exceed the sum of the premiums and other amounts paid for the contract. The bill provided exceptions to this general rule if certain notice and consent requirements are met, and if the insured is (1) an employee at any time during the 12-month period before the insured's death, or (2) a director or a highly compensated employee. Also excluded would be any amount received to the extent the amount is paid to a beneficiary, trust, estate, or member of the family of the insured.

The bill would have required that:

1. an employee be notified in writing that the applicable policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued;
2. an employee provide written consent to being insured under the contract and that coverage may continue after the insured terminates employment; and
3. an employee be informed in writing that the employer will be a beneficiary of any proceeds payable upon the death of the employee.

The bill would also have required that every employer owning one or more COLI policies file an information return.

Except for a contract issued after the date of enactment pursuant to an exchange described in Section 1035 for a contract issued on or prior to that date, the bill would have been effective for contracts issued after the date of the enactment of the bill.

The bill, which was identical to one introduced during 2004 in response to several well publicized cases involving COLI programs, required affirmative notification and consent from employees. Most companies have already made this a standard practice.

Bill to Prevent dividends received from certain corporations from receiving a reduced tax rate – S. 1363

Senator Max Baucus (D, MT) introduced S. 1363, to prevent dividends received from corporations in "tax havens" from receiving a reduced tax rate. The bill would have modified the definition of "qualified foreign corporation" of Section 1(h)(11)(C), relating to dividends on stock readily tradable on a United States securities market.

The maximum capital gains rate for qualified dividend income taxed as net capital gain would apply only to qualified foreign corporations if:

1. the stock with respect to which such dividend is paid is readily tradable on an established securities market in the United States, and such
2. corporation is created or organized under the laws of a foreign country which has a comprehensive income tax system which the Secretary determines is satisfactory.

The bill was not co-sponsored by Senator Charles Grassley (R-IA), the Chairman of the Senate Finance Committee, reportedly because of concerns that the legislation was overly

broad and would affect non-inverted companies. However, Chairman Grassley has previously supported efforts to deny the reduced rates on capital gains and dividend income to inverted companies. The bill did not come to a vote.

Bill to Permit the Consolidation of Life Insurance Companies with Other Companies – S. 1293

Senate Finance Committee Member Jim Bunning (R, KY) introduced S. 1293 which would have allowed the consolidation of life insurance companies with other companies.

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

To the extent that a consolidated net operating loss is allowed or increased by reason of the amendments made by the bill, the bill provided that such loss may not be carried back to a taxable year beginning before January 1, 2005.

In his remarks before the Senate on introduction of the "Bill to Permit the Consolidation of Life Insurance Companies with Other Companies", Senator Bunning stated, " The staff of the Joint Committee on Taxation has recommended repeal of two of the three limitations addressed by my bill on the grounds of needless complexity. The third limitation is, in effect, merely a minimum tax on life insurance company income. That limitation should have been repealed when the alternative minimum tax was enacted, and certainly has no place in the current tax laws. I should also note that Congress included in the tax cut vetoed by then-President Clinton in 1999 much of what is contained in this legislation."

Source: "Bunning Bill Would Permit Consolidation of Life Insurance Companies," Tax Notes Today, 2005 TNT 129-27.

President's Tax Advisory Panel Recommendations

Nearing year-end, President Bush's Advisory Panel on Federal Tax Reform (the "Panel") met to discuss two tax reform alternatives: a "Simplified Income Tax" and a "Modified Progressive Consumption Tax." The two approaches share many common features for individuals and corporations but differ significantly in the treatment of capital gains and business investment.

The recommended options were described as satisfying the goals set for the panel by President Bush to propose reform options that would achieve simplicity, fairness, and promotion of economic growth. As part of the effort to achieve tax fairness, the panel noted that both options would maintain the progressivity of the current income tax system and that the distribution of tax liabilities among different income levels generally should remain unchanged. The panel also revisited a proposal for an add-on value-added tax (VAT) as part of a streamlined income tax

system. Panel members reached a conclusion that they could not recommend an add-on VAT as part of their report but indicated that the final report would spell out both the positive and negative aspects of a VAT for future public consideration.

Both proposals contain provisions of interest to insurers. Perhaps the most concerning provision to insurers was the proposal to tax the inside build-up of life and annuity policies. All insurers should be interested in the provisions associated with lower corporate rates and repeal of AMT. Mortgage insurers should be particularly interested in the provisions associated with the cap on the mortgage interest deduction applicable to individuals, and health insurers should be particularly interested in the provisions associated with the cap on health insurance premium deductions applicable to small businesses and individuals.

The panel was commissioned in January 2006 to provide a report with revenue-neutral policy options for reforming the Federal tax code. However, President Bush's political weakness may limit his ability to push significant, and possibly unpopular, changes to the tax code through Congress. The report itself was a huge undertaking. Now, with the recommendations made, implementation will likely prove to be an uphill battle.

Similarities and differences in tax reform options

For corporations, both proposals would reduce the top corporate rate from 35 percent to 32 percent, repeal the corporate alternative minimum tax (AMT), and eliminate most tax preferences, including possibly tax credits. In addition, both proposals would extend the corporate-level tax to cover all large partnerships and other business entities. The major difference is that the modified progressive consumption tax proposal would provide for immediate expensing of capital investments and the elimination of interest expense deductions. In addition, the panel

discussed in some detail the need for special rules covering financial services income under the consumption tax option.

Some Washington wits recently came up with a song to the tune of "Camelot." A few excerpts:

"A law was made a distant moon ago here. / Simplicity must constantly be fought. / The tax code must be Byzantine and Greek here / In Tax-A-Lot."

Final verse: *"Let's close by saying we are sentimental / Remembering all the tax breaks we have got. / For there is simply not / A more congenial spot / For happy-ever-lobbying / Than here in Tax-A-Lot."*

Source: Tom Herman, "Change in Law Offers Incentive to Settle with IRS on Shelters," The Wall Street Journal, January 18, 2006, page D2.

Highlights of the Simplified Income Tax

In addition to reforms common to both proposals, the simplified income tax proposal would make the following changes:

- Businesses would pay no U.S. tax on active foreign income.
- Foreign dividends would be repatriated tax-free.
- Interest and financing costs would be allocated on a world-wide basis.
- Residency rules for U.S. tax purposes would be based on location of corporate management instead of legal incorporation.
- Asset depreciation classes for businesses with annual receipts above $1 million would be reduced to four.

- Small businesses (less than $1 million annual receipts) would be taxed based on a “cash in” and “cash out” method, with current expensing for all property except for land and buildings. New information reporting rules would require small businesses with receipts above a certain threshold to maintain business bank accounts and credit cards for which financial institutions would be required to report income and expenses to the IRS.
- Corporate dividends paid on U.S.-based income would be subject to a 100 percent exclusion.
- Capital gains from the sale of corporate stock held for more than one year would be subject to a 75 percent exclusion. The remaining capital gains would be taxed at ordinary rates.

The proposal included a change in the taxation of inside build-up of life insurance policies which drew criticism from the life insurance industry. In the proposal, the panel recommended treating the increase in value in some life insurance and annuity policies as current income that would be subject to tax annually, at the taxpayer’s ordinary income tax rate. The panel recommended grandfathering annuities, life insurance arrangements, and deferred compensation plans currently in existence, so that they would continue to be taxed under current-law rules.

The Department of the Treasury received several comment letters regarding the proposal to tax inside build-up of certain life insurance and annuity policies in the President's Tax Advisory Panel Recommendations. Columbus Life Insurance Company, National Life Group, Representative Jim Gerlach (R, PA), Pacific Life Insurance Company, and Northwestern Mutual all urged Treasury to avoid negating the value of life insurance products in the course of any future tax reform initiatives.

Highlights of the Modified Progressive Consumption Tax

This option shares many features with the simplified income tax reform plan but provides different rules for capital gains and business investment.

For businesses, the most significant difference is the proposal to expense all capital investments and eliminate interest deductions. Panel members discussed the need to provide a limited transition allowance for past depreciation. The following are some other major differences:

- Corporate cash flow would be taxed at a 32 percent rate. Corporate cash flow was defined as business income from the sale of goods and services minus capital expenses and compensation.
- Major capital projects generating negative cash flow would be addressed by providing a loss carryforward with an interest adjustment.
- Special rules would be needed to cover financial services income.
- The proposed consumption tax would be border-adjustable and would subject imports to tax but exclude exports.
- Capital gains, interest, and dividends would be taxed at a 15 percent rate.

chapter 3

Reserves

Introduction

The major natural disasters which occurred during 2005 are expected to affect the way insurance companies reserve for exposures as diverse as aviation and energy. Business Insurance reported that "Katrina will… cause the industry to rethink cat models… It is pretty clear that these models failed to capture all the exposures from Katrina, including the increased demand for repair services, the storm surge and business interruption losses, among other factors." The report also noted that catastrophe retentions will be nudged upward, as many of the large, global catastrophe programs were exhausted by Katrina. [There will also be] an increased focus on exposure rating and the use of cat models and identification of exposure arising out of non-modeled cat perils such as floods."[49]

While the insurance market at large wrestled with big storm losses, the IRS and courts focused on older and more common reserve issues, such as what constitutes a change in accounting method. American Family Mutual Insurance Company lost a District Court case in which it claimed that it was entitled to an additional adjustment under Section 481 for its unearned premiums. In a legal memorandum the IRS determined that a taxpayer's treatment of deferred and uncollected premiums was an unauthorized change in accounting method. Separately, the IRS granted an extension of time for a request for change in accounting method.

In addition to these developments, the IRS released its prevailing state assumed and applicable Federal interest rates and issued a Revenue Ruling determining that a non-life insurance company's additions to a premium stabilization reserve were return premiums for purposes of determining the amount of premiums earned on insurance contracts during the taxable year under Section 832(b)(4).

49. "Reinsurers Face Upheaval After Big Storm Losses," Business Insurance, October 28, 2005.

The Ten Most Costly World Insurance Losses, 1970-2005[1]

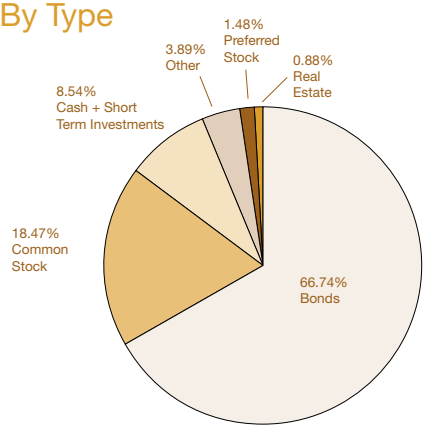
($ in millions)

Rank	Date	Country	Event	Insured loss in 2004 U.S. dollars[2]
1	Aug. 25-29, 2005	U.S.[2]	Hurricane Katrina	$34,000
2	Aug, 23, 1992	U.S., Bahamas	Hurricane Andrew	21,542
3	Sept. 11, 2001	U.S.	Terrorist attacks on WTC, Pentagon and other buildings	20,035
4	Jan. 17, 1994	U.S.	Northbridge earthquake (magnitude 6.6)	17,843
5	Sep. 2, 2004	U.S., Caribbean: Barbados, et al.	Hurricane Ivan; damage to oil rigs	11,000
6	Aug. 11, 2004	U.S. Caribbean: Cuba, Jamaica, et la.	Hurricane Charley	8,000
7	Sep. 27, 1991	Japan	Typhoon Mireille	7,831
8	Jan. 25, 1990	France, U.K., et la.	Winterstorm Daria	6,639
9	Dec. 25, 1999	France, Switzerland, et la.	Winterstorm Lothar	6,578
10	Sep. 15, 1989	Puerto Rico, U.S. et la.	Hurricane Hugo	6,393

1) Poverty and business interruption losses, excluding life and liability losses. As of November 2005.
2) Adjusted to 2004 dollars by Swiss Re.
Note: Loss data shown here may differ from figures shown elsewhere for the same event due to differences in the date of publication, the geographical area covered and other criteria used by organizations collecting the data.

Source: The Insurance Information Institute Fact Book 2006, Insurance Information Institute, 2006, page 94.

Investments, Property / Casualty Insurers, 2004
Investments By Type



Source: The Insurance Information Institute Fact Book 2006, Insurance Information Institute, 2006, page 25.

American Family Mutual[50]

The U.S. District Court ruled against American Family Mutual Insurance Company finding that American Family cannot claim any additional adjustment under Section 481 because Section 832(b)(4)(C) provides explicit instructions for the transition adjustment for unearned premiums.

In 1986, Congress amended Section 832(b)(4), reducing to 80% the amount of unearned premiums insurers were to use in calculating the current year's increase in unearned premiums. The reduction would have allowed 20% of the unearned premiums from the 1986 tax year to escape taxation. To avoid this, Congress prescribed a transition adjustment in Section 832(b)(4)C).

Taking the position that Section 832(b)(4) represented an accounting change, American Family claimed an additional benefit under Section 481, which requires taxpayers to make certain adjustments to their taxable income if a change in a

50. American Family Mutual Insurance Co. v. U.S., 376 F. Supp. 2d 909 (2005).

method of accounting requires the adjustments to avoid a resulting duplication or omission of income.

The District Court concluded that American Family's arguments were "creative but unfounded in law or logic." Further, the Court ruled that American Family cannot use Section 481 as justification for an adjustment of its unearned premiums because those premiums do not meet the criterion in Section 481 that they be either duplicated or omitted income resulting from a change in a method of accounting.

ILM 200504030[51]

The IRS determined that Taxpayer's change in treatment of reserves for deferred and uncollected premiums was an unauthorized change in accounting method. Taxpayer, a life insurance company, previously recognized the deferred and uncollected premium as reported in its statutory annual statement and included in its reserves the obligations associated with the deferred and uncollected premiums for Federal income tax purposes.

However, in year two, Taxpayer began removing the obligations associated with the deferred and uncollected premiums from the computation of its tax reserves for Federal income tax purposes. The following year, Taxpayer submitted a Form 3115 (*Application for Change in Accounting Method*) requesting a change in method of accounting so as to no longer report into underwriting income deferred and uncollected premiums for Federal income tax purposes.

The IRS determined that no change in the methodology of computing Taxpayer's life insurance reserves was involved and that the action that Taxpayer took in year two was subject to the normal procedures for securing the Commissioner's approval for a change in method of accounting. Thus, it was an unauthorized

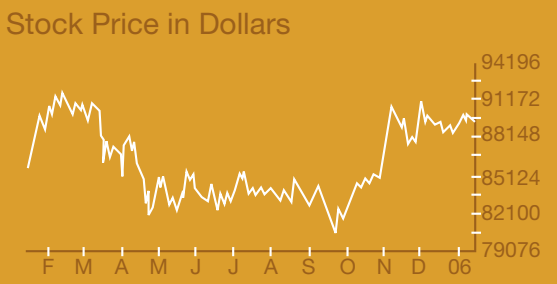
51. ILM 200504030 (January 28, 2005).

change. In addition, the IRS determined that Taxpayer's attempt to secure permission to change the deferred and uncollected premiums on the underwriting side for a year three change involved the same material item that was involved in the year two change relating to deferred and uncollected premiums on the reserve side.

Taxpayers should be cautious in assuming that any change in tax reserves is always subject to Section 807. In this case, the IRS concluded that since no change in reserve methodology was involved, the change in accounting method from including uncollected premiums in tax reserves to not including them in tax reserves would not be considered an item under 807. Further, because the item was not an automatic change, consent would need to be obtained from the Commissioner.

Berkshire Hathaway Inc. reported a 48% decline in third-quarter earnings, as nearly $3 billion in preliminary insurance losses from hurricanes Katrina and Rita slashed the holding company's results.

Source: Richard Gibson, "Berkshire Hathaway Net Slides on Impact of Hurricane Losses," Dow Jones Newswires, November 3, 2005, B3.



Source: New York Stock Exchange, January 16, 2006: http://www.nyse.com/about/listed/lcddata.html?ticker=BRKA&fq=D&ezd=1Y&index=5

Rev. Proc. 2005-72[52] and Rev. Proc. 2005-73[53]

The IRS prescribed the loss payment patterns/discount factors and the salvage discount factors, respectively, for the 2005 accident year. These factors are for use in computing discounted unpaid losses and estimated salvage recoverable under Sections 846 and 832. These Revenue Procedures apply to any taxpayer that is required to discount unpaid losses under Section 846, or that is required to discount estimated salvage recoverable under Section 832.

These Revenue Procedures, as in the prior year, include composite discount factors as promised by Revenue Procedure 2002-74.

PLR 200512005[54]

The IRS released PLR 200512005, granting an extension of time for a request for change in accounting method under Sections 832(b)(4) and 832(b)(5).

Taxpayer timely filed its Federal income tax return, along with an original Form 3115 requesting permission to change its method of accounting to comply with the provisions of Sections 832(b)(4) and 832(b)(5). Subsequently, Taxpayer determined that the original Form 3115 should have been filed with the IRS under the advance consent provisions of Rev. Proc. 97-27[55]. Accordingly, Taxpayer requested an extension of time under Treas. Reg. Section 301.9100-1(c) to file an application on Form 3115 to change the method of accounting.

The IRS determined that based on the facts and representations submitted by the Taxpayer, the requirements of Treas. Reg. Section 310.9100-1—that the taxpayer acted reasonably and in good faith, and that granting relief would not prejudice the

52. Rev. Proc. 2005-72, 2005-49, I.R.B. 1078.
53. Rev. Proc. 2005-73, 2005-49, I.R.B. 1090.
54. PLR 200512005 (March 25, 2005).
55. Rev. Proc. 97-27, 1997-21 I.R.B. 10.

interests of the government—had been satisfied. Accordingly, an extension of time was granted, and the Form 3115 was treated as timely filed under the provisions of Rev. Proc. 97-27.

Rev. Rul. 2005-33[56]

The IRS held that a non-life Insurance Company's additions to a premium stabilization reserve are return premiums for purposes of determining the amount of premiums earned on insurance contracts during the taxable year under Section 832(b)(4).

Insurance Company's premium stabilization reserves are funds that it maintains under its group insurance contracts to stabilize the group policyholders' premiums over a number of years. Rather than rebate amounts already included in gross premiums written to group policyholders based on experience, Insurance Company retains the amounts in premium stabilization reserves to pay extraordinary claims or to offset future premium increases for those policyholders. The premium stabilization reserves are refundable to the group policyholders if the contracts are cancelled. Thus, the premium stabilization reserves are not part of Insurance Company's surplus.

The IRS determined that the amounts that Insurance Company adds to its premium stabilization reserves with respect to group insurance contracts are return premiums under Treas. Reg. Section 1.832-4(a)(6)(i). Therefore, those amounts are subtracted from gross premiums written to compute premiums earned on insurance contracts under Section 832(b)(4). When Insurance Company subtracts amounts from its premium stabilization reserves in the future to pay for insurance coverage on behalf of the same group policyholders, the amount subtracted will increase gross premiums written under Treas. Reg. Section 1.832-4(a)(4)(ii)(B).

56. Rev. Rul. 2005-33, 2005-23 I.R.B. 1155.

Rev. Rul. 2005-29[57]

The IRS released prevailing state assumed and applicable Federal interest rates (AFR) for tax years beginning after December 31, 2003, supplementing Rev. Rul. 92-19[58]. Revenue Ruling 2005-29 provides new rates for calculating the reserves for life insurance and supplementary total and permanent disability benefits, individual annuities and pure endowments, and group annuities and pure endowments. Under Section 807(d)(2)(B), the interest rate to compute reserves must be the greater of the AFR or the prevailing state assumed interest rate. Therefore, the applicable Federal rates are also supplemented.

Applicable Federal Interest Rates – For Purposes of Section 807	
Year	Interest Rate
2004	4.82
2005	4.44
Prevailing State Assumed Interest Rates	
A. Life Insurance Valuation:	
Guarantee Duration (Years)	Calendar Year of Issue (2005)
10 or Fewer	5.00
11-20	4.75
21 or More	4.50
As these rates exceed the applicable Federal rate for 2005 of 4.44 percent, the interest rates to be used for this product under Section 807 are those specified in this table.	

57. Rev. Rul. 2005-29, 2005-21 I.R.B. 1080.
58. Rev. Rul. 92-19, 1992-13 I.R.B. 4.

B. Single Premium Immediate Annuities and Annuity benefits involving life contingencies arising from other annuities with cash settlement options and from guaranteed interest contracts with cash settlement options:	
Calendar Year of Issue	Valuation Interest Rate
2004	5.50
As the prevailing state assumed rate exceeds the applicable Federal rate for 2004 of 4.82 percent, the valuation interest rate of 5.50 percent is to be used for this product under Section 807.	
C. Other Annuities and Guaranteed Interest Contracts Valued on an Issue Year Basis:	
Since the state rate varies from 4.25% to 6.25%, in some cases the Federal rate should be used, while in others the state rate should be used.	

Massachusetts Mutual Life Insurance Co. v. U.S.[59]

The U.S. Federal Court of Claims denied summary judgment in Massachusetts Mutual Life Insurance Co. v. U.S. regarding when the right to receive supplemental premium income is "fixed."

Massachusetts Mutual Life Insurance Co. (MassMutual) underwrote group accident and health insurance policies to employers (Plan Sponsors). In 1984, MassMutual began offering a Minimum Premium Plan (MPP) Rider to holders of Group Policies as an option to the traditional benefits funding method.

The IRS audited MassMutual's Federal income tax returns for the tax years 1981 and 1984 through 1987 and proposed to adjust the taxable income amount for those years and assess deficiencies. The parties reached agreements regarding all claims under the audit except those related to the Minimum Premium Plans and Supplemental Premiums. MassMutual brought suit in Federal Claims Court.

59. Massachusetts Mutual Life Insurance Company v. United States, 66 Fed. Cl. 217 (Fed. Cl,. 2005).

The Claims Court determined that summary judgment was not appropriate because matters of material fact existed. The Court specifically found that it was not possible to determine whether: 1) Supplemental Premiums were due prior to MPP Rider termination; 2) Supplemental Premiums were earned through performance prior to MPP Rider termination; and 3) MassMutual's right to receive Supplemental Premiums was subject to any substantial contingencies. Because finding of these facts was necessary to the determination of the all events test, the Court determined that a trial would be necessary. A date to establish a schedule for trial was pending at the time of this publication.

chapter 4

Captives

Introduction

Captive insurance companies continue to be an important component of the risk management strategy of their parent companies. The use of captives can be attributed to increasing premium costs, difficulty in insuring certain types of risk, and rating structures that reflect trends in the market instead of individual loss experience.

The IRS continued to clarify what arrangements it considers to be insurance for Federal tax purposes. In Revenue Ruling 2005-40 the IRS addressed the risk distribution requirement of a purported insurance contract under four fact scenarios. Significantly, in one scenario involving LLCs treated for tax purposes as disregarded entities, the IRS determined that the arrangement did not adequately distribute risk and did not constitute insurance.

The IRS also released a Private Letter Ruling which examined an insurance arrangement between a taxpayer and its captive. In PLR 200538004 the IRS confirmed that a captive insurance company's income is excludable from gross income for Federal income tax purposes under Section 115 but denied another company's exemption in PLR 200538039. Finally, the IRS released an audit technique guide for new vehicle dealerships which focuses on examination of a business's related entities.

Rev. Rul. 2005-40[60]

The IRS issued guidance on the qualification of certain arrangements as "insurance" for Federal income tax purposes. Rev. Rul. 2005-40 specifically addresses the risk distribution requirement of a purported insurance contract under the four fact scenarios listed in the ruling.

60. Rev. Rul. 2005-40, v

Situation 1: X, a domestic corporation that owns and operates a fleet of vehicles representing a significant volume of independent, homogeneous risks, entered into an arrangement with Y, an unrelated domestic corporation, whereby Y "insures" X against the risk of loss arising out of the operation of its fleet. Y does not "insure" any entity other than X.

The IRS concluded that, although the arrangement may shift the risks of X to Y, those risks are not, in turn, distributed among other insureds or policyholders; therefore, the arrangement between X and Y does not constitute insurance for Federal income tax purposes.

Situation 2: Same as in Situation 1, except that, in addition to its arrangement with X, Y enters into an arrangement with Z, a domestic corporation unrelated to X or Y, whereby Y also "insures" Z against the risk of loss from the operation of its own fleet. The amounts Y earns from its arrangements with Z constitute 10 percent of Y's total amounts earned during the taxable year and 10 percent of the total risks borne by Y.

The IRS found that the fact that Y also enters into an arrangement with Z does not change the conclusion that the arrangement between X and Y lacks the requisite risk distribution to constitute insurance because Y's contract with Z is insufficient to distribute X's risk.

The conclusions of this Ruling in Situations 1 and 2 are an affirmation of the verbal position of the IRS on the risk distribution issue with regards to a single insured or a single substantial insured and are consistent with the case law cited (e.g., *Humana*[61]); however, the Ruling does not apparently take into consideration the Tax Court's contention in *Gulf Oil Corp. v. Commissioner*[62] that "a single insured can have sufficient unrelated risks to achieve adequate risk distribution."

61. Humana Inc. v. Commissioner, 881 F. 2d 247, 252 (6th Cir. 1989).
62. Gulf Oil Corp. v. Commissioner 89 T.C. 1010 (1987).

Situation 3: X conducts its courier transport business through 12 LLCs of which it is the single member. The LLCs are disregarded entities. Y "insures" the LLCs against the risk of loss arising out of the operation of the fleet. None of the LLCs account for less than 5 percent, or more than 15 percent, of the total risk assumed by Y. Y does not "insure" any entity other than the LLCs.

The IRS determined that because Treas. Reg. Section 301.7701-2(a) provides that if an entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner, Y has entered into an "insurance" arrangement only with X. Therefore, the risks are not distributed among other insureds and the arrangement between X and Y does not constitute insurance.

The conclusion in Situation 3 regarding the status of a single member limited liability company as an "insured" separate from its owner is consistent with the IRS's conclusion in a 2004 legal memorandum (ILM 200442031), in which the IRS determined that the necessary risk distribution was absent in certain indemnity arrangements between LLCs and a captive, leading to the conclusion that they were not insurance contracts for Federal tax purposes.

There are those that argue that the shifting of risk is a legal concept, and as the LLC is a separate legal entity, if not a separate tax entity, risk shifting has occurred.

Situation 4: Same as in Situation 3, except that each LLC elects to be classified as an association.

The IRS concluded that the arrangements between Y and each LLC shift a risk of loss from each LLC to Y. The arrangements between the 12 LLCs and Y constitute insurance for Federal income tax purposes. Y is an insurance company, and the 12

LLCs may be entitled to deduct amounts paid under those arrangements as insurance premiums.

The conclusion in Situation 4 is consistent with Revenue Ruling 2002-90[63].

Notice 2005-49[64]

Concurrent with the release of Rev. Rul. 2005-40, the IRS released Notice 2005-49, requesting comments on issues that should be addressed in future guidance concerning the standards for determining whether an arrangement constitutes insurance for Federal income tax purposes. Comments were to be submitted to the IRS on or before October 3, 2005.

The IRS received comment letters from several companies and associations regarding Rev. Rul. 2005-40, including:

- Reinsurance Association of America
- The National Association of Mutual Insurance Companies
- The Property-Casualty Insurance Association
- Vermont Captive Insurance Association
- Captive Insurance Companies Association
- Groom Law Group
- Vohland & Campbell LLC
- Pearson Merriam

PLR 200518010[65]

The IRS ruled that a reinsurance arrangement between a parent company, its subsidiaries, unrelated entities, and its foreign captive insurance company is not insurance for Federal income tax purposes.

Parent is a tax-exempt health care provider. State law caps the malpractice liability of a health care provider if the provider

63. Rev. Rul. 2002-90, 2002-52 I.R.B. 985.
64. Notice 2005-49, 2005-27 I.R.B. 14.
65. PLR 200518010 (May 6, 2005).

maintains liability insurance issued by an insurer admitted in the State. Parent Group obtained liability insurance issued from an admitted insurer which the admitted insurer then ceded to a wholly-owned foreign subsidiary of Parent (Sub). Fronting Company F and Fronting Company G issued a binder letter covering Parent Group's risks. The Binder Letter required that Sub provide a letter of credit, and that Parent provide a parental guarantee.

The IRS determined that adequate risk shifting and risk distribution was not present, and the risks of the unrelated insureds was not considered insurance. Accordingly, Section 4371 did not apply.

The IRS's conclusion with regards to the members of the Parent Group is consistent with prior rulings given the presence of the parental guarantee which negated risk shifting between the members of the Parent Group and the Sub. The IRS's conclusion with respect to the unrelated corporations seems to be an aggressive interpretation of the application of risk distribution given the fact the unrelated corporation's risks would be distributed (e.g., pooled) with the unrelated members of the Parent Group.

PLR 200538004[66]

Consistent with prior rulings on government agencies formed for the purpose of pooling insurance risks under Section 115, the IRS confirmed that a captive insurance company's income was excludable from gross income for Federal income tax purposes under Section 115.

The IRS determined that Company, which was formed as a captive insurance company by an association of publicly-owned electric utilities, was established under the authority of state law to pool the insurance risks of its member public utilities. By providing such insurance coverage in a cost effective manner,

66. PLR 200538004 (September 23, 2005).

Company was helping its members protect their financial integrity and was thereby performing an essential governmental function. Therefore, the IRS ruled that the income of Company was excludable from gross income for Federal income tax purposes under Section 115.

The U.S. Government Accountability Office (GAO) completed a study regarding regulation of risk retention groups (RRGs), insurers authorized to write insurance on a national basis. The GAO report suggests that the states, through the NAIC, develop regulatory standards for RRGs including:

- filing financial reports on an regular basis using a uniform accounting method.
- meeting NAIC's risk-based capital standards.
- complying with the Model Insurance Holding Company Regulatory Act.

The report also suggests that states consider standards similar to the accreditation standards for traditional insurers relating to laws, regulatory processes and procedures, and personnel.

Source: "GAO Recommends Common Regulatory Standards for Risk Retention Groups," Foley and Lardner Information Bulletin, October 2005.

PLR 200538039[67]

As the cost of workers' compensation insurance increases, many organizations have sought to mitigate their costs by self-insuring. As evidenced by this ruling, in organizing self-insurance groups, taxpayers must carefully document compliance with Section 501 if they wish to obtain tax exempt status.

Taxpayer was formed to enable members of a specific industry to fund the costs of workers' compensation insurance coverage through a self-insurance program.

67. PLR 200538039 (September 23, 2005).

The IRS determined that although Taxpayer was formed in accordance with certain state workers' compensation laws and was accepted by the state workers' compensation board as a group self-insurer, Taxpayer had not provided any documentation showing that it was specifically created or established by the state. For this reason the IRS concluded that Taxpayer did not meet the requirements of Section 501(c)(27)(B).

Additionally, the IRS concluded that because Taxpayer's primary activity was the rendering of particular services for individual persons, Taxpayer does not meet the requirements of Section 501(c)(6).

IRS Audit Guide

The IRS released an audit technique guide for new vehicle dealerships which focuses on examination of a business's related entities. The guide addresses extended service contracts and other aftermarket products and producer-owned reinsurance company issues.

Vehicle Service Contracts: The guide lists the areas which the IRS considers to be issues for dealer agent and dealer obligor programs. It also lists the documents which should be requested in an audit, including copies of the extended service contracts, promotional materials, and agreements.

Producer-Owner Reinsurance Companies (PORCs): The guide addresses potential legal positions in the audit of PORC transactions including PORC entities that fail to qualify as insurance companies, pricing of insurance products which is not arms length, and sham transactions. The guide also outlines the use of Section 953(d) elections and the application of the Section 4371 excise tax for PORCs incorporated in foreign jurisdictions. Finally, the guide explains the use of Sections 501(c)(15), 806, and 831(b) in the formation of PORCs.

chapter 5

Tax Shelters

Introduction

Although IRS guidance related to tax shelters decreased significantly during 2005, tax shelters continued to be an area of importance, complexity, and often confusion, to corporate taxpayers. Early in the year, the IRS provided interim guidance relating to tax shelter provisions of the American Jobs Creation Act of 2004[68]. The two notices generally addressed penalty and disclosure provisions. Nearing year-end, the IRS provided a settlement initiative under which taxpayers could resolve the tax treatment of twenty-one "potentially abusive" tax transactions with the IRS, and Congress passed legislation containing tax shelter provisions.

The developments which most directly affected insurance companies were those having to do with the Schedule M-3, which was required to be filed for the first time by companies filing Forms 1120 with the IRS. Up to the filing deadline, the IRS maintained a frequently asked questions page specifically to address issues related to the preparation and filing of the Schedule M-3. Taxpayers and their representatives were encouraged to submit new questions, which the IRS answered and posted on the website.

Mid-year the IRS released a draft version of the 2005 Schedule M-3 and related instructions, which included two new line items. At the time of the draft release, the IRS included instructions for taxpayers filing Forms 1120-PC and 1120-L. Later in the year, however, the IRS announced that it would defer the Schedule M-3 planned effective date for insurance companies until 2006. In late December 2005, the IRS released a new draft version of the Schedule M-3 for corporations filing 1120-PC and 1120 L income tax returns.

68. American Jobs Creation Act of 2004, Pub. L. 108-357.

Gulf Opportunity Zone Act Provisions

The Gulf Opportunity Zone Act (Pub. L. 109-135) clarified that the penalty for failing to disclose participation in a reportable transaction applies to returns and statements, without regard to the original or extended due date for such return or statement. The provision also clarified that underpayments attributable to an understatement resulting from participation in a listed transaction or a reportable transaction with a significant tax avoidance purpose are not subject to accuracy-related penalties under Section 6662 to the extent that an accuracy-related penalty under Section 6662A is imposed on such underpayment, and that accuracy-related penalties under Section 6662A do not apply to underpayments to which a fraud penalty under Section 6663 is applied. The law also clarified the statute of limitations period for unreported listed transactions and clarified the Section 6708 penalty for failing to comply with the Section 6112 list maintenance requirements.

Announcement 2005-80[69]

The IRS provided a settlement initiative under which taxpayers may resolve the tax treatment of twenty-one "potentially abusive" tax transactions with the IRS. The announcement describes who is eligible to participate, the eligible transactions, the settlement terms, and the settlement procedures. Taxpayers had until January 23, 2006, to notify the IRS of their intent to participate.

Taxpayers who participated in the settlement were required to pay (1) 100 percent of the taxes owed, (2) interest, and (3) depending upon the transaction, either one-quarter or one-half of the penalty the IRS would otherwise seek. The 21 eligible transactions, which include both listed and non-listed transactions, include the following:

69. Announcement 2005-80 (November 14, 2005).

Listed transactions (Penalty=½ of the maximum)

- Tax avoidance using inflated basis;
- Intermediary transactions;
- Common trust fund straddle tax shelter; and
- Distributions of encumbered property.

Listed transactions (Penalty=¼ of the maximum)

- ESOP-owned S corporation;
- Abusive Roth IRA transactions;
- Welfare benefit funds under Section 419A(f)(5);
- ESOPs holding stock in an S corporation;
- Stock compensation;
- Distributions by charitable remainder trusts; and
- Certain trust arrangements seeking exemption from Section 419.

Various other transactions were also included.

Notice 2005-11[70]

A taxpayer may incur a penalty under Section 6707A with respect to each failure to provide a disclosure statement that is required to be attached to an original or amended return filed after October 22, 2004, regardless of whether the original return was due on or before October 22, 2004. Unless disclosure is required on an amended return filed after October 22, 2004, the language of this guidance suggests that disclosure must be made on the originally filed return to avoid penalties, and subsequent disclosure on an amended return will not immunize the taxpayer from penalties.

70. Notice 2005-11, 2005-7 I.R.B. 493.

Imposition of penalty: The taxpayer will be subject to a penalty under Section 6707A with respect to each failure to (1) attach a reportable transaction disclosure statement to an original or amended return; or (2) provide a copy of a disclosure statement to the Office of Tax Shelter Analysis (OTSA), if required. While only a single penalty will be imposed with respect to any single disclosure failure, the full penalty will be imposed for each partial disclosure failure, and penalties will be applied separately for each failure to disclose.

Rescission authority: In determining under Section 6707A(d) whether rescission would promote compliance with the requirements of the Code and effective tax administration for reportable transactions other than listed transactions, the Commissioner will take into account all of the relevant facts and circumstances.

Notice 2005-12[71]

Notice 2005-12 provides interim guidance relating to Section 6662A, as added by the American Jobs Creation Act of 2004[72], and Sections 6662 and 6664, as amended by the Jobs Act. Specifically, Notice 2005-12 sets forth rules and standards for adequate disclosure for purposes of Sections 6662A and 6664(d), a special rule for amended returns under Section 6662(e), and various rules relating to "disqualified tax advisors" under Section 6664(d).

Adequate disclosure: Under the Jobs Act, a 20 percent penalty may be imposed on any reportable transaction understatement, but the penalty rate increases to 30 percent if the taxpayer fails to adequately disclose the transaction. Notice 2005-12 provides that a taxpayer has adequately disclosed the facts for purposes of Section 6662A, and Section 6664(d)(2)(A), if the taxpayer has filed a disclosure statement in the form and manner prescribed by

71. Notice 2005-12, 2005-7 I.R.B. 494.
72. American Jobs Creation Act of 2004, Pub. L. 108-357.

Treas. Reg. Section 1.6011-4(d) (i.e., a Form 8886) or the taxpayer has been deemed to have satisfied its disclosure obligations under Rev. Proc. 2004-45[73] (i.e., Schedule M-3), as applicable, or any other published guidance prescribing the form and manner of disclosure under Section 6011.

Amended return: Notice 2005-12 provides that for purposes of determining the amount of any reportable transaction understatement, the IRS will not take into account an amendment or supplement to a return filed after the dates specified in Treas. Reg. Section 1.6664-2(c)(3) and Notice 2004-38[74], or any amendments thereto, which are the dates after which a taxpayer may not file a "qualified amended return." Thus, in determining whether adequate disclosure has been made, the IRS will take into account not only originally filed returns but also any amended return that qualifies as a "qualified amended return."

Disqualified tax advisor: Notice 2005-12 provides various definitional rules relating to "disqualified tax advisor," "material advisor," "participation" in the organization, management, promotion, or sale of a transaction, and "disqualified compensation arrangements." A tax advisor, including a material advisor, will not be treated as a disqualified advisor if the tax advisor's only involvement is rendering an opinion regarding the tax consequences of the transaction and the tax advisor does not suggest material modifications to the transaction that assist the taxpayer in obtaining the anticipated tax benefits.

Regulations: The IRS intends to issue regulations implementing Section 6662A and the amendments to Sections 6662 and 6664.

73. Rev. Proc. 2004-45, 2004-31 I.R.B. 140.
74. Notice 2004-38, 2004-21 I.R.B. 949.

In 2002, the IRS announced a new policy to request tax accrual workpapers when it audits returns that claim a tax benefit from certain tax avoidance transactions that the IRS has identified as abusive.

Recently, many taxpayers have received requests for their tax accrual workpapers related to disclosures they made as a result of ownership interests in pass-through entities which participated in certain tax avoidance transactions that the IRS has identified as abusive.

Many questions have arisen with respect to this policy. In August, the IRS posted to its website answers to 13 "frequently asked questions" related to tax accrual workpapers. In addition, Deborah Nolan, Commissioner of the Large and Mid-Size Business Division, issued a memorandum emphasizing that the Internal Revenue Manual makes clear that a request for tax accrual workpapers is mandatory when a taxpayer claims the benefit of a listed transaction for a return filed on or after July 1, 2002, and for some returns filed before that date.

2005 Schedule M-3

The IRS released a draft version of the 2005 Schedule M-3, *Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More*, and related instructions for use by certain corporate taxpayers filing Forms 1120. The 2005 Form 1120 Schedule M-3 is for use with Form 1120 returns filed for calendar year 2005, fiscal years that begin in 2005 and end in 2006, and tax years of less than 12 months that begin and end in 2006.

The draft 2005 Schedule M-3 includes two new line items—one line for the new domestic production activities deduction and another line for interest expense—and reflects other modifications to the 2004 Schedule M-3 including a specific clarification for insurance companies reporting intercompany dividends. The draft also clarifies that, for insurance companies included in consolidated Forms 1120, the amounts reported in column (a) of Parts II and III. *Income (Loss) per Income Statement*, must be reported on the same accounting method as is used to report the amount of net income (loss) on Part I, line 11, *Net Income (Loss) per Income Statement of Includible Corporations*, which for insurance companies is usually statutory accounting.

The draft 2005 Schedule M-3 also clarifies that normally intercompany dividends will have been eliminated in financial accounting consolidation eliminations included on Part I, line 4, *Worldwide Consolidated Net Income*. However, an insurance company may be required to include intercompany dividends on Part I, Line 11, so that the amount reported there agrees with statutory accounting net income (Annual Statement).

As this publication goes to press, the IRS has just released Notice 2006-6, announcing that the categories of reportable transactions under Treas. Reg. Section 1.6011-4 will be revised to remove the category of transactions with a significant book-tax difference. Because of the reporting requirements of Schedule M-3, the IRS has concluded that the book-tax difference category of reportable transactions is no longer necessary.

Schedule M-3 for Corporations Filing 1120-PC and 1120-L

Late in the year, the IRS released draft Schedules M-3 and instructions for corporations that file Forms 1120-PC and 1120-L. When finalized, these Schedules M-3 will be used by property and casualty insurance corporations and life insurance corporations that have total assets of $10 million or more, starting with tax years ending on or after December 31, 2006.

The IRS and Treasury announced plans to meet with affected stakeholder groups to discuss the new Schedules M-3 and instructions and expect to finalize the schedules during 2006.

During the first year taxpayers are required to file Schedule M-3, certain portions will be optional as was the case with Schedule M-3 for regular C-corporation Form 1120 filers. The draft instructions for the Schedules M-3 were modeled after the 2005 Form 1120 M-3 instructions released for comment on June 23, 2005. Final changes to the 2005 Form 1120 M-3 instructions will be incorporated into the insurance company Schedules M-3 following the comment period.

Insurance companies should review the relevant draft Schedule M-3 and instructions and assess the impact of these disclosure requirements on their current tax information reporting systems. Insurers may find that they will require significant time and cost to implement and incorporate these increased disclosure requirements within their current systems.

Schedule M-3 Reporting for Insurance Companies

The IRS announced that it would defer the planned effective date of Schedule M-3 reporting for life and property and casualty insurance companies that file Forms 1120L and 1120PC. Schedule M-3, now filed in conjunction with income tax returns by certain large and mid-size corporations to reconcile net income, will be required for 1120L and 1120PC filings for tax years ending on or after December 31, 2006. Previously, the IRS planned to require Schedule M-3 for these filings for tax years ending on or after December 31, 2005. The delayed filing deadline does not apply to corporate groups with C corporation parents which file the Form 1120.

Schedule M-3, *Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More*, is used by corporations that file Form 1120 to reconcile their financial accounting income to their taxable income. Corporations filing Form 1120 started using Schedule M-3 for tax periods ending on or after December 31, 2004. The IRS had planned to implement the use of Schedules M-3 for other types of entities during 2004 and 2005.

Taxpayers should use the delay to prepare their accounting systems and staff for the requirements of the Schedule M-3, which will be implemented next year.

State Tax Shelter Developments

The following is a summary of the reportable transaction disclosure requirements applicable in states that have enacted tax shelter legislation as of September 13, 2005[75].

California

Effective for taxable years beginning on or after January 1, 2003, California taxpayers are required to file: (i) copies of all Federally required disclosures, and (ii) any California required disclosures, including those relating to California Listed Transactions identified by the Franchise Tax Board (FTB) and any additional reportable transactions determined by applying the Federal rules, substituting "California income and franchise taxes" for "Federal income taxes." A California taxpayer is required to attach a copy of IRS Form 8886 and/or Schedule M-3 to its California income/franchise tax return for each taxable year the taxpayer participates in a reportable transaction. For the first time a reportable transaction is disclosed with the FTB, a taxpayer must also file a duplicate copy of IRS Form 8886 and/or Schedule M-3.

Furthermore, California taxpayers are required to attach IRS Form 8271, *Investor Reporting of Tax Shelter Registration Number*, to their California tax returns.

Illinois

Illinois generally conforms to the Federal regulations and does not impose additional disclosure requirements with respect to Illinois-specific transactions. As a result, Illinois taxpayers are required to only disclose Federal reportable transactions with their Illinois tax returns.

For taxable years ending on or after December 31, 2004, an Illinois taxpayer is required to attach a copy of IRS Form 8886 and/or Schedule M-3 to its Illinois income tax return for each

75. This summary merely addresses the disclosure requirements and not, e.g., registration or list maintenance requirements, penalty provisions, extension of the statute of limitations, etc.

taxable year the taxpayer participates in a reportable transaction. For the first time a reportable transaction is disclosed with Illinois, a taxpayer must also file a duplicate copy of IRS Form 8886 and/or Schedule M-3.

In addition, taxpayers who participated in a reportable transaction in a taxable year ending before December 31, 2004, are required to file "catch-up" disclosures on their first return due (without regard to extensions) on or after July 30, 2004.

Furthermore, Illinois taxpayers are required to attach IRS Form 8271, *Investor Reporting of Tax Shelter Registration Number*, to their Illinois tax returns.

New York

While New York legislation authorizes the Commissioner of Taxation and Finance to expand the scope of required disclosures, to date no such guidance has been issued. Unless or until any such guidance is provided, New York taxpayers generally are required to only disclose Federal reportable transactions with their New York tax returns.

For tax returns filed on or after June 13, 2005, New York taxpayers are required to attach duplicates of their Federal disclosure statements (IRS Form 8886 and/or Schedule M-3) and any related information to Form DTF-686, *Tax Shelter Reportable Transactions - Attachment to the New York State Return*. Form DTF-686 is then attached to the taxpayer's New York tax return.

New York taxpayers are required to file "catch-up" disclosures with their first tax return filed on or after June 13, 2005.

Connecticut

On May 25, 2005, Connecticut passed legislation that piggybacks Federal disclosures. Rather than require any disclosure to Connecticut taxing authorities, this legislation merely provides that, effective for taxable years beginning on or after January 1, 2005, Connecticut will impose a penalty if a Connecticut taxpayer fails to disclose to Federal authorities its participation in a Federal listed transaction.

Minnesota

Minnesota generally conforms to the Federal regulations and does not impose any additional disclosure requirements with respect to Minnesota-specific transactions. As a result, Minnesota taxpayers are required to only disclose Federal reportable transactions with their Minnesota tax returns. For the first return with an extended due date on or after September 11, 2005, a Minnesota taxpayer is required to either attach a copy of its Federal disclosure statements with its Minnesota tax return or mail a copy of the Federal disclosure statements to the Minnesota Department of Revenue by the due date of the Minnesota return.

For taxable years ending on or after December 31, 2005, a Minnesota taxpayer is required to attach a copy of the Federal disclosure statement to its Minnesota tax return for each taxable year the taxpayer participates in a reportable transaction. For the first time a reportable transaction is disclosed with Minnesota, a taxpayer must also mail a duplicate of the Federal disclosure statement.

In addition, Minnesota taxpayers are required to file "catch-up" disclosures with their first return due on or after September 11, 2005.

Reorganizations

chapter 6

Introduction

There were very few IRS developments in the area of corporate reorganizations during 2005. However the lack of administrative developments did not reflect the pace of corporate reorganizations in the marketplace. Late in 2005 the Wall Street Journal reported that "After several years in which companies have closely watched costs and avoided the management challenges of big deals, world-wide merger and acquisition volume for the year to date surged to more than $2.3 trillion," marking the most active market for transactions "since the all-time high of $3.3 trillion in deals in 2000."[76]

The insurance industry contributed to this record-setting merger and acquisition volume. Several mammoth deals announced during 2005 will be closed during 2006, including Lincoln National's acquisition of Jefferson-Pilot and Swiss Re's purchase of General Electric's insurance business.

In October 2005, Lincoln National Corp. announced intentions to acquire Jefferson-Pilot Corp. in a $7.5 billion deal. The combined company's $15.6 billion market capitalization will place it among the top four life insurance companies in the U.S.[77] A month later, Swiss Re agreed to purchase "most of General Electric Co.'s insurance business for $6.8 billion, creating the world's largest reinsurer by premiums and accelerating a consolidation of the industry that has seen the emergence of a few giant players in the past five years."[78] In a smaller merger, Physicians Insurance Company of Wisconsin, Inc. announced that it had signed an agreement to merge with ProAssurance Corporation[79].

76. Dennis K. Berman and Jason Singer, "Awash in Cash: Cheap Money, Growing Risks --- Big Mergers Are Making a Comeback As Companies, Investors Seek Growth," The Wall Street Journal, 5 November 2005, A1.
77. Lavonne Kuykendall, "Lincoln National to Buy Rival Jefferson-Pilot," The Wall Street Journal, 11 October 2005, C4.
78. Charles Fleming and Kathryn Kranhold, "Swiss Re to Buy GE Insurance Units --- Deal for $6.8 Billion Vaults Reinsurer to No. 1 Position; U.S. Firm Boosts Buyback," The Wall Street Journal, 19 November 2005, A3.
79. Dow Jones News Service, December 8, 2005.

Merger activity was not limited to the U.S. The Wall Street Journal reported that "After four years on the sidelines, European insurance companies, with their bottom lines finally in order and operations slimmed down and restructured, are poised to re-enter the mergers-and-acquisitions arena." Old Mutual PLC proposed a $5.75 billion takeover of Sweden's Skandia AB, and other companies are expected to seek smaller acquisitions to boost market clout in niche segments[80].

PLR 200544006[81]

In the first of four insurance-related reorganization releases during the year, the IRS was requested to rule on the Federal income tax consequences of a proposed transaction in which a mutual life insurance company is to convert to a stock life insurance company. The IRS held that the transaction qualified as a tax-free reorganization.

Company is a State A mutual life insurance company and the common parent of an affiliated group of corporations filing a consolidated Federal income tax return. Mutual Holding Company is a State B corporation and the common parent of an affiliated group of corporations filing a consolidated Federal income tax return.

Stock Holding Company is a wholly-owned subsidiary of Mutual Holding Company that holds all of the stock of Sub 1 and Sub 2. Transitory will be a State A mutual holding company formed by Company for purposes of the proposed transaction. Transitory will have no capital stock.

Company proposes to convert from a mutual life insurance company to a stock life insurance company controlled indirectly by Mutual Holding Company. The following restructuring transactions will occur pursuant to a plan of reorganization and merger agreement:

80. Goran Mijuk, "European insurers study deals after 4-year hiatus," Dow Jones NewsWires, November 4, 2005.
81. PLR 200544006 (November 4, 2005).

Step 1: Company will form Transitory.

Step 2: Company will convert into a stock life insurance company by amending and restating its articles to authorize the issuance of capital stock. The Company Membership Interests will become membership interests in Transitory pursuant to State A law and the Policyholders' membership interests in Company will be extinguished. The Policyholders will receive no consideration other than membership interests in Transitory. Company will issue all of the Company Stock to Transitory.

Step 3: Transitory will merge with and into Mutual Holding Company, and the membership interests of members in Transitory will become membership interests in Mutual Holding Company, and concurrently all membership interests of Transitory will be extinguished.

Step 4: Mutual Holding Company will contribute to Stock Holding Company all of the Company Stock.

The Proposed Transaction will not change the contractual provisions of the policies held by the Policyholders, and it will not reduce or alter the guaranteed benefits and values and rights of the Policyholders.

The IRS ruled that the Conversion would constitute a reorganization under Sections 368(a)(1)(E) and 368(a)(1)(F). No gain or loss would be recognized by Company on the issuance of its stock in exchange for Company Membership Interests in the Conversion.

The ruling reaffirms past rulings in that conversion from a mutual to a stock company is a tax-free corporate reorganization.

IRS Reviews Life/Non-life Consolidated Returns[82]

In late September, Tax Analysts reported that the IRS was reviewing the provision in the consolidated return regulations that prevents new life insurance subsidiaries from joining the consolidated group for five years if there is a reasonable expectation there will be a separation of profit and loss activities.

At the American Bar Association's annual course on consolidated returns, an IRS official stated that the IRS had received several questions about the provision by life insurance groups seeking to establish reinsurance subsidiaries. Fleming noted that in the case of certain proposed reinsurance subsidiaries there would be a separation of profit and loss activities, which could create a problem under Treas. Reg. Section 1.1502-47.

The IRS continues to maintain that it cannot rule on the issue but is looking into what can be done to address the concern.

LMSB Directive

In addition to the Private Letter Ruling addressing a mutual insurance company's conversion to a stock company, the IRS Large and Midsize Business Division (LMSB) announced a directive that provides Examining Agents with a benchmarking tool designed to assist them in determining whether to audit the tax treatment of certain transaction costs in connection with a taxpayer's acquisition (or disposition) of a trade or business.

In the Directive, the IRS acknowledges that "much uncertainty and controversy in the capitalization area has been focused on which transaction costs must be capitalized under Section 263(a) as costs related to the acquisition of a new trade or business and

82. Tandon, Crystal. "Life-Nonlife Consolidated Group Issue Under Consideration, IRS Official Says," Tax Notes Today, 2005 TNT 185-4, September 27, 2005.

which costs were amortizable as start up costs under Section 195 or were otherwise deductible under Section 162(a)."

The IRS states that for M&A transaction costs occurring in tax years ending on or before December 31, 2003, resolution of agreed LMSB examinations have generally resulted in the capitalization of all transaction costs (incurred up to the consummation of the acquisition) within a range of 50% to 65% of the applicable transaction costs.

The IRS directs that for tax years ending on or before December 31, 2003, in determining whether to audit the propriety of the taxpayer's treatment of transaction costs in the acquisition of a trade or business, the auditor should consider whether the taxpayer's return position falls within the 50% to 65% range of the applicable transaction costs.

Top Ten Insurance-Related Mergers and Acquisitions Reported in 2004[1]

$ in millions

Rank	Buyer	Target	$ Deal Value[2]
1	UnitedHealth Group Inc.	Oxford Health Plans, Inc.	$5,002.1
2	Coventry Health Care Inc.	First Health Group Corp.	1,755.1
3	Occum Acquisition Corp.	Safeco Life and Investments	1,350.0
4	Swiss Reinsurance Co.	Valley Forge Life Insurance Co.	690.0
5	PacifiCare Health Systems, Inc.	American Medical Security Group, Inc.	502.0
6	Humana Inc.	CPHP Holding Inc.	408.0
7	HIP Insurance Co. of New York	ConnectiCare, Inc.	350.0
8	Devlin Group LLC	Forethought Financial Services, Inc.	280.0
9	Prudential PLC	Life Insurance Company of Georgia	253.9
10	Jefferson-Pilot Corp.	US group business of The Canada Life Assurance Co.	200.0

1) At least one of the companies involved is a US -domiciled company. List does not include terminated deals.
2) At announcement.

Source: The Insurance Information Institute Fact Book 2006, Insurance Information Institute, 2006, page 14.

Demutualization Issues

The IRS released two Private Letter Rulings regarding the use of demutualization proceeds in employer plans.

PLR 200551028[83]

Company A, a dissolved corporation, maintained Plans X and Y. Plans X and Y were terminated shortly after Company A ceased operations. In each case, a group annuity contract to pay all plan benefits was purchased from Insurance Company B with Company A as the policyholder. Company A established a qualified replacement plan (Plan Z) under Section 4980, received a reversion from the terminating plans, and paid the appropriate excise tax of the employer reversion under Section 4980.

Following the termination of Plans X, Y, and Z and the distribution of assets, the mutual life insurance company from which the group annuity contracts had been purchased, Insurance Company B, became a stock insurance company, Company C. Company C stock was received as demutualization compensation to the policyholders of Plan X, Plan Y, and Plan Z. Receiver D sold the Company D stock and deposited all of the net proceeds in the appropriate trust account.

The IRS determined that since the Plan X trust was not in existence at the time of the demutualzation of Insurance Company B, and all obligations and claims of Plan X were satisfied prior to the demutualization, such shares cannot be considered assets of Plan X. Because Company A will not receive any surplus amounts from Plan X, Plan Y, or Plan Z following such distributions, no reversion subject to tax under Section 4980 will occur.

83. PLR 200551028 (December 23, 2005).

PLR 200551029[84]

Union A maintained Plan X, a multiemployer defined benefit pension plan which terminated January 31, 1987. To effectuate this termination, the assets of Plan X were used to purchase a group single premium guaranteed annuity contract, from Insurance Company B, with Union A as the contract holder.

Effective October 26, 2001, Insurance Company B converted from a mutual insurance holding company into a stock company (Insurance Company C). As part of this demutualization, eligible policyholders exchanged their membership interests for shares of Insurance Company C.

Union A, as the contract holder of the group annuity contract, received shares of Company C stock. The shares were sold, and the proceeds are being held in an interest bearing account. Union A proposed to amend Plan X to increase benefits of Plan X participants.

The IRS determined that since the Plan X trust was not in existence at the time of the demutualization of Insurance Company B, and all obligations and claims of Plan X were satisfied prior to the demutualization, such shares could not be considered assets of Plan X. Accordingly, the proceeds realized as a result of the receipt and subsequent sale of Company C stock may not be treated as assets of Plan X, and Plan X may not be amended to increase benefits as a result of the demutualization proceeds.

84. PLR 200551029 (December 23, 2005).

chapter 7

International

Introduction

Globalization is not new to the insurance industry, but the pace and complexity of international transactions has increased. Because the insurance industry is a global industry, international developments are increasingly important in companies' decision-making, risk-managing, and compliance functions. As the corporate world has grown smaller, the demand for transparency associated with international transactions has increased, and international bodies such as the Organization for Economic Co-operation and Development (OECD) have intensified programs designed to curb harmful tax avoidance practices and promote consensus on the taxation of international products and services.

Individual governments have also begun paying more attention to cross-border transactions, as evidenced by the volume of rulings and legislation in this area. The IRS has published final regulations under Section 864 relating to the determination of income of foreign insurance companies that is effectively connected with the conduct of a trade or business within the U.S. In addition, the IRS issued Notice 2005-38, providing guidance for U.S. companies that elect to repatriate dividends from foreign subsidiaries and began reviewing and updating its files relating to foreign insurers and reinsurers who entered into excise tax closing agreements. There were also developments related to the excise tax, Section 953(d) elections, information reporting, foreign bank accounts, and transfer pricing.

With the potential to affect both the U.S. and international taxation of insurance companies, the OECD published its long-awaited first draft on the attribution of profits to permanent establishments - Part IV - Insurance. The 56 page document is the final part of the OECD's report on permanent establishments. The other parts comprise Paper I - General Considerations; Paper II - Banks; and Paper III - Global Trading of Financial Instruments.

Effectively Connected Income

An important element of the U.S. international taxation regime is the allocation of individual items of gross receipts or gross income between U.S. sources and foreign sources. Foreign taxpayers are subject to U.S. income tax only on their income effectively connected with the conduct of a U.S. trade or business, and non-effectively-connected income from U.S. sources.

Final Regulations Under Section 864[85]

The IRS issued final regulations relating to the determination of income of foreign insurance companies that is effectively connected with the conduct of a trade or business within the U.S. The regulations provide that the general rule excluding stock from the asset-use test does not apply to stock held by a foreign insurance company unless such company owns directly, indirectly, or constructively 10 percent or more of the vote or value of the company's stock. The 10 percent threshold is intended to distinguish portfolio stock held to fund policyholder obligations and surplus requirements from investments in a subsidiary. These final regulations, which adopted the language of the proposed regulations without change, were effective on October 3, 2005.

Foreign insurers with "effectively connected income" in the U.S. should review their investments in subsidiaries to determine how these final regulations may affect them.

85. T.D. 9226, 2005-43, I.R.B 772.

Top Ten Insurance Countries By Direct Premiums Written 2004

US $ in billions

Rank	Country	Nonlife Premiums[1]	Life Premiums	Total Premiums		
				Total Amount	Percent change from prior year	Percent of total world premiums
1	United States[2]	603,018	494,818	1,097,836	3.8	33.84
2	Japan[3]	105,587	386,839	492,425	4.1	15.18
3	United Kingdom	105,241	189,591	294,831	15.9	9.09
4	France	65,811	128,813	194,624	20.5	6.00
5	Germany	106,261	84,535	190,797	12.1	5.88
6	Italy	46,728	82,083	128,811	14.6	3.97
7	Canada[4]	40,232	29,509	69,741	16.8	2.15
8	South Korea[3]	19,944	48,680	68,623	14.1	2.12
9	Netherlands[5]	27,064	31,512	58,577	12.6	1.81
10	Spain	32,311	23,592	55,903	18.2	1.72

1) Includes accident and health insurance.
2) Nonlife premiums include state funds; life premiums include an estimate of group pension business.
3) April 1, 2003 - March 31, 2004.
4) Life business expressed in net premiums.
5) Nonlife premiums are gross premiums including a small amount of reinsurance premiums.

Source: The Insurance Information Institute Fact Book 2006, Insurance Information Institute, 2006, page 1.

Qualified Dividends

The American Jobs Creation Act provides for a special one-time tax deduction of 85 percent of certain foreign earnings that are repatriated. The deduction is part of a domestic reinvestment strategy, and many companies plan to take advantage of the deduction. The IRS has released various guidelines related to the deduction, including Notice 2005-38.

Notice 2005-38[86]

The IRS issued Notice 2005-38, providing guidance for U.S. companies that elect to repatriate dividends from foreign subsidiaries subject to the temporary dividends-received deduction available under the American Jobs Creation Act[87] (AJCA). The Notice supplements Notice 2005-10[88], which primarily addressed the domestic reinvestment plan required by Section 965(b)(4). Notice 2005-38 primarily addresses the limitations on the amount of dividends that a corporate U.S. shareholder of a controlled foreign corporation may treat as eligible for the dividends-received deduction under Section 965(a).

Section 78 Gross-up: The Notice states unconditionally that "Section 78 does not apply to any tax which is not allowable as a credit under Section 901 by reason of Section 965(d)," which refers to the deductible portion of the dividend. As a result, the Section 78 gross-up on a Section 965 dividend, like deemed paid foreign tax credits, is reduced by 85 percent.

Income Tax Accounting Impact of Section 78 Gross-up: In accordance with FASB Staff Position No. FAS 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004*, the tax effects of a planned repatriation under the provisions of AJCA should be recognized in the period in which the company decides to repatriate funds.

Therefore, for a company that has not yet recorded a liability for repatriating earnings under the provisions of Section 965 (or alternatively, has not yet reduced any existing liability for foreign earnings that are not "indefinitely reinvested" under Accounting Principles Board Opinion 23) because it has not yet decided whether any earnings will be repatriated under AJCA, the guidance has no effect on periods prior to May 10, 2005.

86. Notice 2005-38, 2005-22 I.R.B. 1100.
87. The American Jobs Creation Act of 2004, Pub. L. 108-357.
88. Notice 2005-10, 2005-6 I.R.B. 474.

For a company that has already recorded a liability for repatriation under the Act in financial statements for periods ended prior to May 10, 2005, the adjustment needed to reflect any differences in the amount so accrued and the amount now expected to be payable based on the Notice should be reported in the income statement in a manner similar to a change in tax law in the period that includes May 10, 2005.

The issuance of the Treasury guidance resolving the Section 78 gross-up issue may be treated as a Type II subsequent event under FAS 109.

Floods in Mumbai and Bangalore, India pushed up claims rates for motor vehicles. "On an average, 5,500 cars and 15,000 two wheelers are added to the city's vehicle population every month. While the traffic situation has pushed up the claims numbers on an average to around 2,500 per month, the industry fears that the number could go up after the rains. The current year has been a tough year for the motor insurance industry [in India] with natural calamities hitting the country at regular intervals."

Source: "Insurance Claim Go Up," The Times of India, October 24, 2005.

Excise Tax

The IRS issued proposed regulations under Section 4371 relating to payment of excise taxes by disregarded entities. As taxpayers examine these new regulations, they should also review their compliance with the requirements of any excise tax closing agreements which they have entered.

Proposed Regulations Under Sections 4371 and 7701[89]

The IRS issued proposed regulations under which qualified single-owner eligible entities that currently are disregarded as

89. T.D. 9226, 2005-45, I.R.B 930.

entities separate from their owners (disregarded entities) for Federal tax purposes would be treated as separate entities for employment tax and certain excise taxes. These proposed regulations would affect disregarded entities and the owners and employees of disregarded entities in the payment and reporting of Federal employment taxes, as well as their owners in the payment and reporting of certain Federal excise taxes and in registration and claims related to certain Federal excise taxes. Companies owning disregarded entities for Federal income tax purposes should assess the impact of these proposed regulations, particularly with respect to their current employment and/or excise tax withholding and filing obligations.

Under U.S. tax law, certain single-owner eligible entities (under Treas. Reg. Sections 301.7701-1 through 301.7701-3) are disregarded as entities separate from their owners. The disregarded entity rules of Treas. Reg. Sections 301.7701-1 through 301.7701-3 currently apply for all purposes, including employment and excise taxes.

Employment Taxes: The proposed regulations would eliminate disregarded entity status for purposes of Federal employment taxes. A disregarded entity would be regarded for employment tax purposes, and, accordingly, become liable for employment taxes on wages paid to employees of the disregarded entity, and be responsible for satisfying other employment tax obligations.

Excise Taxes: The proposed regulations would eliminate disregarded entity status for purposes of certain excise taxes. An entity that is disregarded for other Federal tax purposes would be required to pay and report excise taxes, required and allowed to register, and allowed to claim any credits (other than income tax credits), refunds, and payments.

The reasons for issuing these proposed regulations include administrative difficulties which have arisen from the interaction

of the disregarded entity rules and the Federal employment tax provisions. The IRS believes that treating the disregarded entity as the employer for purposes of Federal employment taxes will improve the administration of the tax laws and simplify compliance.

Excise Tax Closing Agreements

According to the IRS, certain foreign insurers and reinsurers have not been renewing certificates of residency every three years, as required by their closing agreements. The IRS has also found that letters of credit required to be maintained as security for payment of any potential excise tax are not adequate. In light of this, the IRS has begun contacting foreign insurers and reinsurers to discuss these issues.

Background: Section 4371 imposes a Federal excise tax on certain insurance and reinsurance policies covering U.S. risks issued by foreign insurers or reinsurers. In general, the person required to remit the insurance excise tax is any person who makes, signs, issues or sells an insurance or reinsurance policy subject to the Federal excise tax.

In 1983, the IRS began entering into closing agreements with foreign insurers and reinsurers as a means of providing assurance that premiums paid to certain insurers or reinurers were exempt from excise tax under the provisions of a tax treaty.

New Revenue Procedure to Establish a Treaty-Based Exemption from the Insurance Excise Tax: In October 2003, the IRS issued Revenue Procedure 2003-78[90] to provide a streamlined process for establishing an exemption from the Federal excise tax when the exemption is based on the provisions of an income tax treaty. Closing agreements under the new procedure differ from those under previous revenue procedures in that they allow foreign insurers and reinsurers to “self certify” eligibility for treaty benefits.

90. Rev. Proc. 2003-78, 2003-45 I.R.B. 1029.

While developing the new procedures in Revenue Procedure 2003-78, the IRS discovered that many foreign insurers who had entered into closing agreements in the past, were not complying with the certification renewal provisions of those agreements. As a result, the IRS began contacting those insurers and reinsurers to determine if the taxpayers intend to maintain the agreements current and, if so, the IRS will require correction of any defects.

It is recommended that foreign insurers or reinsurers covered by closing agreements under revenue procedures issued prior to Revenue Procedure 2003-78 consider entering into agreements under the new revenue procedure. In that way, obtaining a certificate of residency from a foreign taxation authority every three years would no longer be required.

Major Japanese life-insurance companies improved their financial health in the latest fiscal year, though profits held steady and policy cancellations continued to outstrip sales.

The insurers said they expect continued cancellations to erode business conditions for the current fiscal year as well. The weak conditions persist despite growing unrealized profits on asset holdings, primarily from domestic stocks and bonds in portfolios. Unrealized profits on stocks held by the six big life-insurance companies rose 21% to 5.7 trillion yen ($52.8 billion) in the fiscal year ended March 31 from 4.7 trillion yen a year earlier.

Source: Hiroshi Inoue, "Japan's Big Life Insurers Report Flat Profits," The Wall Street Journal, May 31, 2005, A7

Section 953(d) Elections

Many companies elect under Section 953(d) to be treated as a domestic corporation for U.S. tax purposes in order to take advantage of favorable U.S. insurance company tax laws. A

controlled foreign corporation that makes this election is subject to tax in the U.S. on its worldwide income but not subject to the branch profits tax or the branch-level interest tax imposed by Section 884. Further, the excise tax imposed under Section 4371 on policies issued by foreign insurers does not apply.

PLR 200540009[91]

The IRS granted a 60-day extension to a foreign insurance company that inadvertently failed to file a timely Section 953(d) election to be treated as a domestic corporation for U.S. tax purposes. The IRS determined that in its request for "9100" relief, the Taxpayer satisfied the requirements of Treas. Reg. Section 301.9100-3 by establishing that it acted reasonably and in good faith, and that granting relief would not prejudice the interests of the government.

This is yet another example of the IRS granting "9100" relief in the context of untimely Section 953(d) elections.

Information Reporting

Final Regulations Under Sections 6043 and 6045[92]

The IRS issued final regulations under Sections 6043 and 6045 requiring information reporting by a corporation if control of the corporation is acquired, or the corporation has a substantial change in capital structure, and the corporation or any shareholder is required to recognize gain under Section 367(a). Also included are final rules concerning information reporting requirements for brokers with respect to transactions described in Section 6043(c).

The final regulations limit information reporting to transactions in which the reporting corporation or any shareholder is required to recognize gain, if any, under Section 367(a). The final rules revise

91. PLR 200540009 (October 7, 2005).
92. T.D. 9230, 2005-52, I.R.B 1198.

the definitions of "acquisition of control of a corporation" and "change in capital structure."

Unlike the temporary regulations, the final regulations do not include the explicit requirement that Form 1099-B include the corporation's address.

The IRS noted that it will continue to consider the proper implementation of the additional information reporting provided under Section 6043A, which was added by the American Jobs Creation Act of 2004[93].

Other International Developments

Transfer pricing has become a more important international tax issue in the last several years, as foreign jurisdictions have begun paying more attention to transfer pricing issues. The U.S. also announced greater scrutiny of transfer pricing arrangements. In addition to the transfer pricing study, the IRS posted to its website a clarification of foreign bank account reporting and released domestic asset/liability percentages.

Separately, the OECD released a draft of its long-awaited Permanent Establishments study for insurance companies.

Transfer Pricing

The IRS Large and Mid-Size Business Division (LMSB) issued a memo providing guidelines for requesting transfer pricing documentation. The purpose of the memo was to convey to agents the results of a recent Treasury Inspector General for Tax Administration (TIGTA) review of LMSB Industry cases with international transfer pricing issues.

93. American Jobs Creation Act of 2004, Pub. L. 108-357.

The issuance of the Transfer Pricing Compliance Directive (January 22, 2003) required that any company under the LMSB's jurisdiction must be asked at the initial IRS audit conference to produce transfer pricing documentation *within 30 days of the request*. TIGTA determined that in some cases transfer pricing documentation was not requested because the transfer pricing issues were de minimus. The memo advised agents that they should not make any decisions regarding materiality of a potential transfer pricing adjustment before the documentation is requested.

The IRS also outlined additional procedures which apply to the beginning of an examination. The IRS indicated that an information document request (IDR) should be issued during the planning process requesting copies of all transfer pricing documentation prepared pursuant to Section 6662(e) in every case in which there is either a Form 5471 or Form 5472. If there is no Form 5471 or Form 5472, inquiry should be made whether the taxpayer engaged in cross border transactions with any entity in which the taxpayer had an economic interest.

Foreign Bank Accounts

The IRS posted to its website a notice on foreign bank account reporting by employees of subsidiary corporations. The announcement was in response to questions regarding whether the filing exception found in the instructions to the Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts*, for officers and employees of certain domestic corporations applies to officers and employees of domestic subsidiaries of such corporations.

The IRS referenced an interpretive ruling that is still in effect. The ruling states that, "an officer or employee of a domestic subsidiary of a domestic corporation which has securities listed on national securities exchanges or which has assets exceeding $10 million and 500 or more shareholders of record need not report that he has signature authority over a foreign financial account of the

subsidiary if he has no personal financial interest in the account and has been advised in writing by the chief financial officer of the parent corporation that the subsidiary corporation has filed a current report which includes that account."

PricewaterhouseCoopers has released an updated version of its International Comparison of Insurance Taxation. The CD Rom released in March 2005 is an updated survey of the accounting and taxation rules that apply to both life and non-life insurance business around the world. The intention of the survey is to give an overview of the situation within each of the 32 countries covered.

Domestic Asset / Liability Percentages

Revenue Procedure 2005-64[94]

The IRS provided the domestic asset/liability percentages and domestic investment yields needed by foreign life insurance companies and foreign property and liability insurance companies to compute their minimum effectively connected net investment income under Section 842(b) for taxable years beginning after December 31, 2003.

The domestic asset/liability percentages are calculated separately for life insurance companies and property and liability insurance companies. For the first taxable year beginning after December 31, 2003, the relevant domestic asset/liability percentages are:

121.7 percent for foreign life insurance companies, and

173.6 percent for foreign property and liability insurance companies.

94. Rev. Proc. 2005-64, 2005-46, I.R.B. 492.

The domestic investment yields are calculated separately for foreign life insurance companies and for foreign property and liability insurance companies. For the first taxable year beginning after December 31, 2003, the relevant domestic investment yields are:

5.5 percent for foreign life insurance companies, and

3.7 percent for foreign property and liability insurance companies.

The IRS also provided instructions for computing foreign insurance companies' liabilities for the estimated tax for taxable years beginning after December 31, 2003.

The revenue procedure is effective for taxable years beginning after December 31, 2003.

The IRS solicited comments concerning Notice 2002-69[95], which allows U.S. shareholders of a foreign insurance company to use the foreign insurance company's historical loss payment patterns in computing the company's insurance reserves under Section 954(i), provided the company has a certain number of years of data and makes an election to use that data. No written comments were received during the comment period.

OECD Permanent Establishments Draft

On June 27, the OECD published the long-awaited first draft on the attribution of profits to permanent establishments (PEs) – Part IV – Insurance. The 56 page document is the final part of the OECD's report.

It is clear that Part IV of the report is heavily influenced by previous work done in relation to Banks. The Drafts propose that a branch

95. Notice 2002-69, 2002-43 I.R.B. 730.

(a PE) should be treated as if it were a separate entity dealing at arm's length with the rest of the entity and with other parties. The proposed approach could significantly affect PE/head office profit attributions and increase taxpayers' compliance burdens.

Key potential issues arising for the insurance industry include:

- Focus on "key entrepreneurial risk takers" (KERTs) who accept and manage risk within the business
- Allocation of reserves, surpluses and associated premiums and investment income to the location(s) where the relevant KERTs reside
- Focus on the methods that may be used to allocate investment income to PEs
- The need for arm's length pricing justification and documentation for all intra-entity transactions
- An acceptance that reinsurance between a PE and its Head Office may be acceptable
- Inter-company reinsurance should be supported by a functional analysis

Background

The purpose of the OECD report is to promote international consensus and consistency in the taxation of permanent establishments. In initiating this report, the OECD recognized that:

- There is considerable variation in the domestic laws of OECD Member countries regarding the taxation of insurance PEs; and
- There is no consensus amongst the OECD Member countries as to the correct interpretation of Article 7 of the OECD model tax treaty (Business Profits), which can lead to double taxation, or sometimes less than single taxation.

As a first step, the OECD developed a working hypothesis as to the preferred approach for attributing profits to a PE. This approach is based on the premise that it is necessary to determine the profits which the PE might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions. The working hypothesis is now the "authorized OECD approach."

It is worth noting that the OECD explicitly rejected any approach based on apportionment of the overall profits/losses of the entity.

Content of Part IV

The first 21 pages of the paper seek to set out, in broad terms, the way in which insurance businesses operate. The paper then explores how, by analyzing the functions and assets and risks of a particular line of business, it should be possible to identify the key value drivers (or Key Entrepreneurial Risk Taking Functions) within that business line.

Key Entrepreneurial Risk Taking Functions are defined as those *"which require active decision making with regard to the taking on and day-to-day management of the individual risks and portfolios of risks that have been identified as the most important…"*[96]

Application of the Authorized OECD Approach

Step 1: Hypothesize the PE as a separate entity

This involves a thorough functional and factual analysis to identify the economically significant activities and responsibilities undertaken by the insurance enterprise as a whole, before identifying which are undertaken by the PE and to what extent.

Key to this analysis is the OECD's proposal that surplus (defined as paid in capital plus accumulated profits or losses not paid out by way of dividend) and technical reserves should be

96. Paragraph 75, Part IV (Insurance).

allocated where the key entrepreneurial risk taking functions are undertaken.

Step 2: Determine the profits under the separate entity assumption

Having hypothesized a PE as a distinct and separate entity, the OECD transfer pricing guidelines are then applied by analogy.

Key proposals affecting the insurance industry are:

- Premiums and investment income will be expected to follow the allocation of surplus and technical reserves under Step 1 above;
- The profit attributed will need to take into account arm's length pricing to reward other functions performed in respect of the business written.

Practical implications of OECD Part IV

Some of the more important issues are:

1. The activity-based approach

The OECD paper determines the location of the "people" functions, primarily relating to risk management, is the factor which determines the location of the profits of the enterprise. In addition, surplus (or capital) is required to support the risks assumed by an enterprise and, in the case of a PE, is attributed by reference to the location where risks are assumed and managed, rather than the other way round.

2. Ownership of investment income

The Draft states that a financial asset should be treated as belonging to the location where the key entrepreneurial risk taking functions have been performed, and, as a result, where the reserves and surplus are allocated. This potentially results in very different allocations of investment income in comparison to current practice.

The Report notes that the Consultation process on Parts I – III has shown there is no single internationally accepted approach for the attribution of capital and that the OECD should therefore limit itself to providing guidance on the principles. A key problem with this approach is the potential for disagreement among tax authorities.

3. Dealings between branch and Head Office

The paper accepts that it is possible for reinsurance between a PE and its Head Office to be effective for tax purposes.

Consistent with the revised draft of Part II is the increased focus in the paper on a threshold for recognizing "dealings" between a PE and different parts of the same enterprise. This appears to reflect a wider anti-avoidance agenda among tax authorities in relation to risk transfers, with the concern being that PEs will, for example, enter into reinsurance transactions with other parts of the insurance company in order to shift risk and manipulate the taxable profits arising in different jurisdictions.

4. Application to Subsidiaries

The report highlights the importance of inter-company reinsurance for some property and casualty insurers. The report stresses the need for an adequate functional analysis as a cornerstone of any comparability analysis on the arm's length character of transactions between associated parties.

5. Dependent Agent PE

The draft does not itself address in detail whether or not a company operating in one country may create a PE of a foreign company in that country. However the draft clearly envisages that such a situation could arise and that as a result a host country would have taxing rights over both the local company (dependent agent) and the foreign company's PE. The paper goes as far as stating that when attributing profits to the dependent agent PE, there are likely to be profits (or losses) over and above the arm's length service fee paid to the dependent agent company as a result of the attribution of surplus, reserves and associated income, including investment income.

6. Implementation of the OECD Report

Once finalized, the conclusions of Parts I-IV of the Report will be implemented through revision of the Commentary on Article 7 of the model Double Tax Treaty, and/or the Article itself. Further practical guidance will be produced in the form of background Reports and/or Chapters of the OECD Transfer Pricing Guidelines. The projected completion date for the project –which entails both refinement and finalization of the Report and revision of the Commentary on Article 7—is no later than January 2007.

7. Next Steps

Insurance groups are strongly advised to familiarize themselves with this paper and to play an active role in shaping the evolution of the OECD's thinking. There has already been extensive public consultation with the Banking Industry on Part II and Part III, which has continued over a period of years, and which PwC has been heavily involved in.

chapter 8

Blue Cross Blue Shield

Introduction

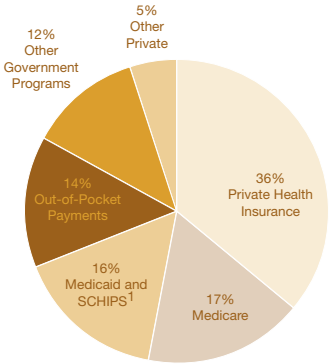
As the nation's health insurance costs continue to rise many companies are turning to alternative approaches to funding healthcare, and Blue Cross Blue Shield plans are looking for innovative new products and distribution channels to answer this demand. The Wall Street Journal reported that Blue Cross and Blue Shield organizations across the country "have agreed to charter a joint bank, aiming to capture more of the growing market for health savings accounts," which allow employees to set aside a certain amount of their pre-tax income to pay for health-related expenses[97]. The plan to charter a BCBS–owned bank is in response to the rise in popularity of such consumer-directed plans. The plans, which combine high deductibles with a savings account, are designed to encourage consumers to spend their health care dollars more discriminately.

Although BCBS organizations are looking forward to new ways of providing and paying for health care, many of the developments in BCBS taxation stem from the transitional tax benefits afforded to BCBS organizations in the Tax Reform Act of 1986[98] (TRA '86) when they lost their tax-exempt status. In June, the IRS issued a 2005 coordinated issue paper addressing the subscriber and other intangible abandonment claims many BCBS organizations have claimed using the fair market value basis provided in TRA '86. The coordinated issued paper relied in part on the original Tax Court's findings in Capital Blue Cross v. Commissioner of Internal Revenue[99]. However, in December 2005 the Court of Appeals for the Third Circuit reversed and remanded that case to the Tax Court, raising questions as to the suitability of the IRS position. Also during 2005 the Federal Circuit Court reversed and remanded a Federal Claims Court opinion that Blue Cross and Blue Shield of Wisconsin must use an estimate to calculate its "unpaid loss reserve" rather than its actual 1987 data during its initial transitional tax year.

97. Fuhrmans, Vanessa. "Blue Cross, Blue Shield Seek Health Savings Plans' Funds" Wall Street Journal, Dec. 5, 2005, page B4.
98. Tax Reform Act of 1986, Pub. L. 99-514.
99. Capital Blue Cross and Subsidiaries v. Commissioner of Internal Revenue, 122 T.C. No. 11, March 12, 2004.

Although conversion activity for the Blues has trailed off in the last couple of years, due mainly to public opposition to Blue conversions in several states, BCBS organizations which have converted to stock corporations continued to grapple with conversion issues. After several years of avoiding this issue, the IRS released a 2005 TAM which determined that a Taxpayer's conversion from a nonprofit non-stock entity to a for-profit stock entity was a material change in structure for purposes of the organization qualifying for Section 833 benefits.

The Nation's Health Care Dollar 2003 Where It Comes From



1) State Children's Health Insurance Program

Source: The Insurance Information Institute Fact Book 2006, Insurance Information Institute, 2006, page 11.

Capital Blue Cross[100]

Capital is a Blue Cross Blue Shield organization which was a tax-exempt entity through December 31, 1986, when Congress enacted Sections 501(m) and 833 providing for the taxation of BCBS organizations on a transitional basis. One of the transition benefits BCBS plans were afforded was the ability to mark to market their assets as of January 1, 1987 for sale or exchange purposes. As of January 1, 1987, Capital had 23,526 group health

100. Capital Blue Cross and Subsidiaries v. Commissioner of Internal Revenue, 431 F.3d 117 (Third Cir., 2005).

insurance contracts outstanding, as well as a number of individual contracts. Thus, Capital performed a valuation to mark its assets, including the group insurance contracts, to market for purposes of sale or exchange.

The IRS took issue with the fact that during both its tax-exempt period and taxable period through the 1994 year, Capital did not record any financial or tax basis in its accounting records for its subscriber-based intangibles. But in its 1994 Federal tax return, Capital claimed $2,648,249 of loss deductions for subscriber groups who cancelled their insurance contracts with Capital. The losses were generated by the 1994 cancellation of 376 group contracts that Capital had owned as of January 1, 1987. At roughly the same time, Capital filed amended tax returns for 1991-1993, claiming loss deductions for subscriber contracts cancelled during those years.

The Commissioner disallowed the deductions, and the Tax Court, agreeing that Capital had not established that a loss occurred, upheld the disallowance of the entire deduction. Capital appealed to the Circuit Court of Appeals.

The Appeals Court held that:

- Losses claimed by BCBS organizations arising from the termination or cancellation of group health insurance subscriber contracts which had a fair market value step-up basis were not precluded from deductibility merely because they did not result from a “sale” of an asset;
- The “Mass asset rule,” which limits a taxpayers’ ability to deduct losses of some intangible assets that are treated as mere components of a larger, single and indivisible asset, did not apply to preclude loss deductions claimed by BCBS organizations for subscriber contracts that were terminated or cancelled;

- If a taxpayer satisfies the burden of proving that its intangible assets may be valued separately and with reasonable precision, thus removing them from "mass asset" status, the Tax Court is obliged to find the correct value; and
- In determining whether the BCBS organization had established its claimed fair market value basis in subscriber contracts for which the BCBS organization claimed a Section 165 loss deduction, the Tax Court improperly discounted expert testimony merely because of "flaws" in an otherwise reasonable valuation.

The Appeals Court reversed and remanded the case to the Tax Court for a determination of Capital's basis in those contracts from the information on record, and any further submissions from the parties that the Tax Court may consider appropriate.

BCBS organizations should assess the impact of this decision and the previously-released IRS Coordinated Issue Paper on their current IRS audit and judicial settlement strategies. The Appeals Court decision contradicts the IRS position as stated in a coordinated issue paper it released in June. Further, those BCBS organizations not currently under examination for this particular issue should assess their tax books and records to formulate or re-confirm their own defensive strategies. All BCBS organizations should be on the lookout for the IRS's response to this decision.

Coordinated Issue Paper

Before the Appeals Court remanded the Capital Blue Cross case to the Tax Court, the IRS released a coordinated issue paper addressing the evolving issue of BCBS organizations claiming abandonment losses for subscriber and other intangible assets using the fair market value basis provided in Section

1012(c)(3)(A)(ii) of the Tax Reform Act of 1986 (TRA '86)[101]. The Paper reaffirms and updates the positions set forth in Notice 2000-34[102], issued by the IRS in July 2000.

TRA '86 allows BCBS organizations to use fair market value as the adjusted basis of assets as of the first taxable year beginning after December 31, 1986. Some BCBS organizations have claimed abandonment loss deductions for individual customer, provider, or employee contracts using aggregate appraisals of the entire customer list, provider network, or workforce in place. Notice 2000-34, states the IRS will be "carefully scrutinizing" the valuations for such deductions and will challenge them where appropriate.

The IRS put the Blues on notice through this Coordinated Issue Paper that it does not intend to become more lenient in this area. The Paper states the IRS position that "The Tax Court's opinion in the [Capital Blue Cross] case provides the Government with additional grounds to sustain adjustments… which may not have been considered during the initial examination." It is unclear, now that the Appeals Court has remanded the Capital Blue Cross case to the Tax Court whether the IRS will modify its position.

Conflicting views of the IRS and the Appeals Court:

The IRS reminded its agents that the Supreme Court found that "the taxpayers' burden of proof with regard to customer-based intangibles may be too great to bear."

The Circuit Court reminded the Tax Court that once the taxpayer has proven a loss occurred and attempted a valuation that the Tax Court is then responsible for finding a value.

101. Tax Reform Act of 1986, Pub. L. 99-514.
102. Notice 200-34, 2000-33 I.R.B. 172.

Blue Cross Blue Shield of Wisconsin v. United States[103]

The Circuit Court of Appeals reversed the Court of Federal Claims' grant of summary judgment for the United States and remanded Blue Cross and Blue Shield Wisconsin (BCW) to the Claims' Court. The Claims' Court previously found that an IRS Closing Agreement did not allow BCW to use its actual 1987 data, rather than the estimate it computed at the beginning of 1987, to calculate its "unpaid loss reserve."

The IRS closing agreement provided, in part, that: "As of January 1, 1987, the taxpayer was an "Existing Blue Cross or Blue Shield organization [under] Section 833. As such, the following attributes apply to the taxpayer as of that date: (e) the taxpayer's January 1, 1987 loss reserve for incurred-but-not-paid claims will be determined in accordance with actual claims paid data for 1987." The IRS contended that because the closing agreement only referred to Section 833, that the actual claims paid data was not intended to be used to calculate the Section 832(b)(4) losses incurred deduction but would be limited to use in the calculation of the Section 833(b) Special Deduction. BCW contended that the because the closing agreement did not specify the code section to which the actual claims paid data clause applied, the natural application would be to apply the clause for all purposes, including the losses incurred deduction of Section 832(b)(4).

The Court of Claims originally held that the closing agreement could be read with more than one meaning, and therefore relied on extrinsic evidence to determine the intent of the closing agreement. On Appeal, the Circuit Court found the extrinsic evidence not persuasive, and reversed and remanded the case to the Federal Court of Claims for reconsideration.

103. Blue Cross & Blue Shield of Wisconsin v. U.S., 94 A.F.T.R. 2d (unpublished) (Fed. Cir., 2004).

The decision emphasizes the importance of ensuring that IRS closing agreements clearly reflect the intent of the parties. The Circuit Court pointed out that there is a possibility that the Court of Claims could find that there is no one reasonable interpretation of the clause in question. In such a case, the Court has the ability to assert that: (a) the closing agreement fails, (b) the closing agreement stands without the application of the clause, or (c) the Court can supply a substitute clause for the agreement to continue to stand.

TAM 200528026[104]

Taxpayer, a for-profit stock corporation that provides health insurance, is a licensee of the Blue Cross Blue Shield Association (BCBSA), which permits Taxpayer to use exclusively BCBSA's name and trademarks. Previously, the Insurance Department approved Taxpayer's conversion from a nonprofit non-stock corporation to a business corporation, and Taxpayer completed the conversion, including the formation of a new corporation and the issuance of both common and preferred stock.

Section 833(c)(2)(C) sets forth two tests for continued qualification as an existing Blue Cross and Blue Shield Organization: (1) there must be no material change in operations, and (2) no material change in structure. In considering the Taxpayer's conversion to a for-profit stock company against the test of material change in structure, the IRS found that Taxpayer's conversion from being a nonprofit non-stock entity to being a for-profit stock entity involved not only changing Taxpayer's articles of incorporation but also a change in how the corporation was governed under state law. The IRS concluded, "Clearly these changes to an organization's structure must be classified as a material change in structure under Section 833(c)(2)(C)."

The IRS indicated that it did not address the first prong of the materiality test under Section 833 because the ruling request

104. TAM 200528026 (July 15, 2005).

addressed no facts related to "high-risk" coverage. This is a reference to the legislative history indicating that an elimination of coverage to a high-risk segment would be considered a material change in operations.

"A group of health clinics and doctors paid thousands of people across the U.S. to undergo unnecessary surgery so they could defraud insurers out of tens of millions of dollars, a lawsuit alleges. Twelve Blue Cross and Blue Shield health-insurance plans sued a group of Southern California health-care clinics, physicians and others they say are involved in the elaborate scheme. The scope of the alleged fraud is vast. The insurers claim the clinics paid recruiters to enlist patients in 47 states, then transported the people to California where they underwent unnecessary and sometimes dangerous outpatient procedures."

Source: "Blue Cross Groups Sue Clinics, Doctors, Claiming Insurance Fraud," The Wall Street Journal, March 14, 2005, page B4.

chapter 9

Products

Introduction

Corporate-owned life insurance (COLI) remained the high-profile product issue in 2005, with the determination of insurable interest stealing the spotlight in both state and Federal COLI cases. The results were mixed for taxpayers, with the 10th Circuit Court of Appeals ruling in Tillman v. Camelot Music Inc. that the employer did not have an insurable interest in the life of an employee, but the District Court ruling that Xcel Energy did have an insurable interest in its employees. The IRS also released a split-dollar audit guide for use by its agents, and the Supreme Court denied certiorari for charitable split-dollar insurance cases.

The IRS continued its focus on variable life and annuity contracts, particularly concentrating on qualification as life insurance, the valuation of life and annuity contracts, and annuitant and contractholder issues. Proposed regulations under Section 7702 address the attained age of an insured, and Revenue Ruling 2005-6 led out the year with the determination that charges taken into account with respect to qualified additional benefits are subject to the expense charge rule for purposes of the guideline premium requirements.

The IRS issued proposed regulations under Section 402 and Revenue Procedure 2005-25 relating to the valuation of life insurance and annuity contracts in employee plans and the determination of the fair market value of a life insurance contract. In addition, the IRS determined in three Private Letter Rulings that exchanges of annuities and life insurance contracts would be disregarded. Finally, in Revenue Ruling 2005-30 and a separate Private Letter Ruling, the IRS addressed life insurance contracts held by trusts.

The IRS also took close looks at separate accounts, issuing final regulations under Section 817(h) and Revenue Ruling 2005-7. Later, using the reasoning of Revenue Ruling 2005-7, the IRS

determined that the look-through rule of Treas. Reg. Section 817(h)(4) applies to an investment in a regulated investment company (RIC) that, in turn, owns an interest in another RIC.

In addition, the IRS issued several waivers under Section 7702 and consistently ruled that service contracts were insurance in several Private Letter Rulings. Other developments related to dividends received from a regulated investment company and VEBA contributions used to purchase life insurance policies.

Split-Dollar

The IRS and the Courts dealt with split-dollar insurance in the following documents.

Split Dollar Audit Guide

The IRS released a Market Segment Specialization Program audit guide which contains the IRS examination techniques for split-dollar life insurance arrangements. The audit guide instructs agents on how to determine whether a company has entered into split-dollar arrangements, who the policy-owner is, and how the economic benefit provided to the employee is being valued.

The audit guide specifically notes that when asking for a copy of the split-dollar arrangement and the life insurance policy, the agent should request any modifications and/or amendments made to the policy after September 17, 2003, the effective date of the final split-dollar regulations.

Addis v. Commissioner[105] & Weiner v. Commissioner[106]

The U.S. Supreme Court denied certiorari for *Addis v. Commissioner* and *Weiner v. Commissioner*, two appeals court decisions which denied taxpayers charitable contribution deductions for payments made in connection with a charitable split-dollar insurance arrangement.

In *Addis v. Commissioner*, the Ninth Circuit Court of Appeals confirmed a Tax Court ruling disallowing charitable contribution deductions for payments to the National Heritage Foundation (NHF) because the receipts substantiating the transfers to the NHF stated the individuals received no consideration, though they expected the NHF to use their funds to pay part of the premiums on life insurance benefiting their trust pursuant to a split-dollar arrangement.

In *Weiner v. Commissioner*, the Ninth Circuit Court of Appeals, affirming the Tax Court, held that Gary Weiner could not deduct payments to the National Heritage Foundation as charitable contributions. NHF used the money to pay premiums for life insurance policies on the lives of Weiner's daughter and son-in-law.

These types of arrangements were generally considered aggressive when originally conceived in the mid 1990s. Congress ended them officially in 1999. The only remaining question was whether any pre-February 8, 1999 arrangements could survive scrutiny. The denial of certiorari in these two cases marks the final chapter in the charitable split-dollar saga.

Split Dollar Comments

The Department of the Treasury invited the general public and other Federal agencies to comment on Split-Dollar Life Insurance Arrangements under final regulation REG- 164754-01[107]. Comments were due by May 24, 2005.

105. Addis v. Commissioner of Internal Revenue, 125 S. Ct. 1334 (2005).
106. Weiner v. Commissioner of Internal Revenue, 125 S.Ct. 1332 (2005).
107. T.D. 9092, 2003-46, I.R.B. 2055.

COLI

The primary focus of corporate-owned life insurance cases was whether the employer had an insurable interest in the lives of employees covered by corporate-owned life insurance policies.

When the New York insurance commission was asked to comment on the practice of investor–owned life insurance, they commented in a letter from the Office of General Counsel, that the investment group did not have an insurable interest, that the insured individual was acting as agent, and that the insurance company could void the policy.

Source: From a letter from the Office of the New York General Counsel issued December 19, 2005.

Tillman v. Camelot[108]

The 10th Circuit Court of Appeals ruled in Tillman v. Camelot Music Inc. that an employer does not have an insurable interest in the life of an employee with no special importance to the company for purposes of purchasing a corporate-owned life insurance policy. Although the 10th Circuit denied Plaintiff's equitable claim of unjust enrichment, the decision provided the Plaintiff with a remedy at law. The 10th Circuit decision that Camelot lacked an insurable interest in Mr. Tillman permits Plaintiff to recover the policy proceeds under Oklahoma statute.

Camelot Music Inc. (Camelot), purchased life insurance on all of its full-time employees, including Felipe Tillman. The personal representative of Mr. Tillman's estate (Plaintiff), brought suit pursuant to the Oklahoma Insurance Code, which provides that if anyone takes out a contract of insurance within the state, on a person in whom it does not have an insurable interest, the insured

108. Tillman ex. Re. Estate of Tillman v. Camelot Music, Inc., 408 F 3d 1300 (C.A. 10 Okla., 2005).

or his representative may recover the proceeds. Plaintiff also alleged the alternative theory of unjust enrichment.
The 10th Circuit examined insurable interest, Camelot's bankruptcy proceedings, and the claims of unjust enrichment.

Insurable Interest: Oklahoma law requires the beneficiary of a life insurance policy to have an insurable interest in the life of the insured in order to be entitled to the proceeds of the policy. The 10th Circuit overturned the District Court on the issue of insurable interest. The 10th Circuit determined that "Camelot has failed to present the additional evidence required to establish Mr. Tillman's special importance to the company."

Discharge in Bankruptcy: Camelot claimed that even if Plaintiff had a right to recover the policy's proceeds under Oklahoma law, the lawsuit fails because the claims were discharged in Camelot's bankruptcy proceeding. Camelot argued that its notice of its proof of claim deadline by publication was sufficient to satisfy the requirements of due process. The 10th Circuit disagreed determining that because Camelot actively concealed the existence of the policies from its employees, publication by notice did not discharge Plaintiff's claim.

Unjust Enrichment: The 10th Circuit upheld the District Court ruling that Camelot was not unjustly enriched when it received the proceeds for the COLI policy after Mr. Tillman died.

On January 23, 2006, the Court of Appeals for the Sixth Circuit overturned the District Court decision in Dow Chemical Co. and Subsidiaries v. U.S. 250 F. Supp.2d 748 (2003), ruling that Dow's corporate-owned life insurance policies were substantive shams and disallowing the accompanying interest deductions. Dow's favorable ruling in the District Court was the only taxpayer-favorable COLI ruling to date.

The increase in stranger-owned and investor-owned life insurance has been troubling to many in the insurance industry. Several insurance companies and trade associations have released statements opposing the products. Jefferson Pilot Financial stated:

"Jefferson Pilot Financial (JPF) has become increasingly concerned that individuals are being recruited to consent to the purchase of life insurance and annuities on their lives… We all have a stake in protecting our franchise, our reputation, and our industry – including the tax-favored status of our products. For all these reasons, and until a change occurs that would merit reconsideration of our position, JPF will no longer accept applications for life or annuity policies sold under SOLI or IOLI programs."

Source: Stephan R. Leimberg, "Stranger-Owned Life Insurance: Killing the Goose that Lays the Golden Eggs!" Tax Notes Today, 200 TNT 108-20, June 7, 2005.

Xcel Energy v. United States[109]

The District Court ruled that although questions of fact relating to the economic substance of a corporate-owned life insurance program precluded summary judgment, the taxpayer had an insurable interest in its employees. The case arose when the IRS denied interest deductions claimed by Xcel's predecessor, Public Service Company of Colorado (PSCo) for policy loan interest relating to the COLI policies.

109. Xcel Energy Inc. v. United States (96 A.F.T.R. 2d 2005-6508 (D. Minn); 2005 WL 2577112).

The Court was presented with two issues: (1) whether the Company had an insurable interest in the lives of its employees, and (2) whether the Company was entitled to deduct policy loan interest or whether the policies lacked economic substance and were substantive shams. The Court ruled in favor of Xcel on the issue of insurable interest but determined that genuine issues of fact remained on whether the policies were substantive shams.

The Court found the Company had an insurable interest in the employees insured under the COLI policies for two primary reasons. First, the Company would benefit from each employee's continued employment, and would also sustain a significant loss not only in the loss of the employee, but in the benefits paid out with each employee's death. Second, existing Colorado law supports the notion that an insured may designate a beneficiary without limitation as to the class of that beneficiary.

The parties agreed that the Company complied with the 4-of-7 rule (e.g., it paid the premiums for the first, fifth, sixth, and seventh years using unborrowed funds). The dispute centered on whether the COLI policies had any practical non-tax effect. The Court found that genuine fact issues remained as to whether the COLI policies were substantive shams.

While the case supports the right of companies to purchase insurance on their employees, it deferred to state law to tighten any "loose standards." Further, the case illustrates that COLI programs must withstand the "business purpose" and "economic substance" tests which serve to shoulder the Taxpayer's burden of proving the validity of COLI policy loan deductions.

PLR 200528023[110]

Corporation purchased corporate-owned life insurance policies on its employees. Corporation's employees never knowingly consented to Corporation's purchase of insurance on their lives nor designated Corporation as the beneficiary. Decedent was

110. PLR 200528023 (July 15, 2005).

an insured employee of Corporation, which received a death benefit after his death. Decedent's estate brought suit against Corporation and received certification of a class action suit consisting of former Corporation employees or their estates.

During the course of the litigation, Corporation and the Settlement Class negotiated a settlement. Subsequently, Decedent's estate and the Settlement Class requested a ruling that the amounts distributed from the settlement fund to the Decedent's estate and members of the Settlement Class are non-taxable death benefit proceeds pursuant to Section 101. The IRS determined that the death benefits paid to Corporation, which were later paid out to Decedents under the class action law suit, were not deductible death benefits to the decedents, but taxable amounts paid to settle litigation.

Qualification as a Life Insurance Contract

The IRS released regulations explaining how to determine the attained age of an insured for purposes of testing whether a contract qualifies as a life insurance contract and a Revenue Ruling holding that for purposes of determining whether a contract qualifies as a life insurance contract or as a modified endowment contract, charges for qualified additional benefits should be taken into account under the expense charge rule.

Proposed Regulations Under Section 7702[111]

The IRS released proposed regulations explaining how to determine the attained age of an insured for purposes of testing whether a contract qualifies as a life insurance contract for Federal income tax purposes.

Neither Section 7702 nor Section 7702A, nor the legislative history of either provision, addresses how an insured's attained

111. 70 FR 29671-01, 2005-25 I.R.B. 1293.

age is determined for purposes of testing a life insurance contract insuring multiple lives under the cash value accumulation test, the guideline premium requirements, or the computational rules of Section 7702(e). The proposed regulations address the determination of attained age for last-to-die and first-to-die life insurance contracts.

The proposed regulations generally would be applicable for contracts issued on or after the date that is one year after the regulations are published as final regulations.

Revenue Ruling 2005-6[112]

IC, a life insurance company, issued a policy with a rider that provides term life insurance coverage on the life of a family member of the individual insured by the policy. IC imposes a charge for the mortality risk that it assumed with the rider and subtracts this charge monthly from the policy's cash value but questioned whether charges for the qualified additional benefits (QABs) should be taken into account under the mortality charge rule of Section 7702(c)(3)(B)(i) or the expense charge rule of Section 7702(c)(3)(B)(ii).

The IRS acknowledged that Section 7702 is silent on the treatment of charges for QABs for purposes of determining whether a contract satisfies the guideline premium requirements. However, under Section 7702(b)(2)(B), charges for QABs are subject to the expense charge rule for purposes of determining whether a contract satisfies the cash value accumulation test. The IRS determined that QABs should not be accounted for under one rule for purposes of the cash value accumulation test, and under a different rule for purposes of the guideline premium requirements. Accordingly, the IRS determined that charges taken into account with respect to QABs are subject to the expense charge rule of Section 7702(c)(3)(B)(ii) for purposes of the guideline premium requirements.

112. Rev. Rul. 2005-6, 2005-6 I.R.B. 471.

The IRS also provided alternatives for issuers whose compliance systems do not currently account for charges for QABs under the expense charge rule. The Ruling was effective February 7, 2005.

"The Pentagon introduced proposed regulations aimed at preventing marketing practices that have exposed military personnel… to high pressure or deceptive sales pitches for insurance and other financial products.

The proposed rules are the Defense Department's first official response to concerns raised in Congress last fall after reports in The New York Times documented abusive sales practices and unsuitable financial products on several military bases… Congress is considering legislation, introduced with bipartisan support, to address problems raised in the reports."

Source: Diana B. Henriques, "Pentagon Proposed Rules to End Abusive Sales Practices on Bases," The New York Times, April 20, 2005, page 3.

Notice 2005-35[113]

The IRS provided procedures under which a list identifying the contracts subject to a closing agreement under Rev. Rul. 2005-6 may be submitted to the IRS in electronic format.

The Revenue Ruling provides three alternatives to life insurance contract issuers whose compliance systems do not currently account for charges for QABs under the expense charge rule of Section 7702(c)(3)(B)(ii). Under the ruling an issuer may request relief in the form of a closing agreement under which contracts will not be treated as having failed the requirements of Section 7702(a) or as MECs under Section 7702A by reason of improperly accounting for charges for existing QABs. The issuer's request for a closing agreement must include a list identifying the contracts for which relief is requested.

113. Notice 2005-35, 2005-21 I.R.B. 1087.

Life Insurance and Annuity Contracts

The IRS released the following on determining the fair market value of a life insurance contract and the amount includible in a distributee's income.

Final Regulations Under Section 402[114]

The IRS released final regulations under Section 402(a) regarding the amount includible in a distributee's income when life insurance contracts are distributed by a qualified retirement plan and regarding the treatment of property sold by a qualified retirement plan to a plan participant or beneficiary for less than fair market value. The IRS also released final regulations under Sections 79 and 83 regarding the amounts includible in income when an employee is provided permanent benefits in combination with group-term life insurance or when a life insurance contract is transferred in connection with the performance of services.

The IRS expects that the regulations will affect administrators of, participants in, and beneficiaries of qualified retirement plans, in addition to employers who provide permanent benefits in combination with group-term life insurance for their employees and employees who receive those permanent benefits; service recipients who transfer life insurance contracts to service providers in connection with the performance of services; and service providers to whom those life insurance contracts are transferred.

The preamble to the regulations specifically notes that the final regulations do not affect the relief granted by the provisions of Notice 2002-8 to the parties to any insurance contract that is part of a pre-January 28, 2002, split-dollar life insurance arrangement. Also, the final regulations do not apply to the transfer of a life insurance contract which is part of a split-dollar life insurance arrangement entered into on or before September 17, 2003, and not materially modified after that date. However, the IRS reminded taxpayers that, in determining the fair market value of property

114. T.D. 9223, 2005-39 I.R.B. 591.

transferred under Section 83, lapse restrictions (such as life insurance contract surrender charges) are ignored.

Section 402: The final regulations retain the rules set forth in the 2004 proposed regulations clarifying that, in those cases where a qualified plan distributes a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance, the fair market value of such a contract (i.e., the value of all rights under the contract, including any supplemental agreements thereto and whether or not guaranteed) is included in the distributee's income, and not merely the entire cash value of the contract.

The final regulations also retain the proposed regulations' provision that, if a qualified plan transfers property to a plan participant or beneficiary for consideration that is less than the fair market value, the transfer is treated as a distribution to the extent the fair market value exceeds the value of the consideration.

Section 83: The final regulations retain the rules set forth in the 2004 proposed regulations under Section 83 that clarify that fair market value is also controlling with respect to life insurance contracts under those Sections and, thus, that all of the rights under the contract (including any supplemental agreements thereto and whether or not guaranteed) must be considered in determining that fair market value.

The final regulations also amend Treas Reg. Section 1.83-3(e) generally to apply the definition of property for new split-dollar life insurance arrangements to all situations involving the transfer of a contract providing life insurance protection. The purpose of the changes to the regulations is to clarify that, unless specifically excepted from the definition of permanent benefits or fair market value, the value of all features of a life insurance policy providing an economic benefit to a service provider (including, for example,

the value of a springing cash value feature) must be included in determining the employee's income.

Section 79: The final regulations amend Treas. Reg. Section 1.79-1(d) to replace the term "cash value" in the formula for determining the cost of permanent benefits with the term "fair market value."

The IRS later issued a correction to the final regulations under Sections 79 and 83. As published, the final regulation contained an error that may have been misleading and, consequently, needed further clarification. The correction to a cite reference was as follows: "On page 50969, column 2, in the preamble, under the paragraph heading 'B. The 2004 Proposed Regulations', line 2 from the top of the column, the language '§ 1.79-(d) to replace the term 'cash' is corrected read '§ 1.79-1(d) to replace the term 'cash.'"

Administrators, participants, beneficiaries, employers, and service providers implicated by a qualified retirement plan making life insurance distributions or other associated transactions should assess whether the corrective language issued by the IRS results in a change to their tax posture.

Rev. Proc. 2005-25[115]

The IRS provided guidance on how to determine the fair market value of a life insurance contract. The guidance modifies and supersedes Rev. Proc. 2004-16[116], released in February 2004 and is applicable to distributions from qualified plans, permanent benefits under Section 79, transfers under Section 83, and contributions to and distributions from nonexempt employees' trusts.

After the issuance of Rev. Proc. 2004-16, the IRS received comments concerning the safe harbors which asserted that the

115. Revenue Procedure 2005-25, 2005-17 I.R.B. 962.
116. Rev. Proc. 2004-16, 2004-10 I.R.B. 559.

formulas did not function well for certain types of traditional policies. In addition, commentators were concerned about the possible double-counting of dividends under the formulas, and the fact that the formulas did not make an explicit adjustment for surrender charges, withdrawals, or distributions.

Rev. Proc. 2005-25 makes adjustments to the safe harbors of Rev. Proc. 2004-16. The Revenue Procedure provides two safe harbor formulas, one for non-variable contracts, and one for variable contracts.

Clarification on Life Insurance Guidance Not Expected Soon

Ann Logan, an attorney in the IRS Office of Chief Counsel, told attendees of a June 2 insurance tax seminar in Washington that clarification of inconsistencies between Notice 2004-61, 2004-41 I.R.B. 596, and Notice 88-128 is "hoped for," but that it will be delayed because of recent vacancies at Treasury and because of IRS concerns over the phrasing of the clarification." The confusion arose over a requirement set forth in Notice 2004-61 regarding the reasonable mortality charge requirements, which is not found in Notice 88-128. The new requirements could impede some contracts that relied on Notice 88-128, according to some in the industry.

Source: Christopher Quay, "Clarification on Life Insurance Guidance Not Expected Soon, Says IRS Official," Tax Notes Today, 2005 TNT 107-8, June 6, 2005.

Annuitant and Contractholder Issues

The IRS ruled on the tax consequences of life insurance policy transfers, the amount of death benefit includible in income to a beneficiary of a trust, and the ownership rights of a taxpayer's life insurance policies held in a trust.

Policy Transfers

PLR 200518061[117]

Taxpayer has two grantor trusts, Trust 1 and Trust 2. Trust 1 holds a life insurance policy insuring the life of Taxpayer. Taxpayer proposes, for valuable consideration, to transfer the life insurance policy from the trustees of Trust 1 to the trustees of Trust 2.

The IRS determined that because Trust 1 and Trust 2 are grantor trusts of Taxpayer, Taxpayer is treated for Federal income tax purposes as the owner of all of the assets of both trusts. Therefore, the proposed transfer of the insurance policy, even though for valuable consideration, will be disregarded for Federal income tax purposes.

PLR 200514001[118] and PLR 200514002[119]

In two identical rulings the IRS determined that the transfer of two whole life insurance policies from one trust to another would be disregarded for Federal income tax purposes and that the "transfer-for-value" rule of Section 101(a)(2) would not diminish the exclusion from gross income for amounts received by the beneficiaries of the policies.

Trust 1 is an irrevocable trust created to benefit Taxpayer's beneficiaries. Trust 1's assets consist of two whole life insurance policies. Trust 2 is an irrevocable trust created for the benefit of Taxpayer's descendants. Trust 1 will transfer the policies to Trust 2 in exchange for consideration equal to the fair market value of the policies.

The IRS determined that Taxpayer will be treated as owning the consideration for the transfer of the insurance policies both before and after the transaction. The transaction will therefore be disregarded for Federal income tax purposes.

117. PLR 200518061 (May 6, 2005).
118. PLR 200514001 (April 8, 2005).
119. PLR 200514002 (April 8, 2005).

ILM 200504001[120]

Taxpayer had two life insurance policies with Insurer. Taxpayer reduced the death benefits on the first policy but paid premiums up to the date of the policy's conversion. Taxpayer surrendered the second policy.

A class action lawsuit was brought against Insurer for fraudulently inducing class members "to surrender, borrow against or otherwise withdraw values from their existing policies in order to purchase new policies." In 2001, Taxpayer was awarded money in a class action lawsuit, including certain amounts with respect to the first policy. The Taxpayer asserted that no portion of the settlement award represented punitive damages, but that the damages represented the recovery of actual out-of-pocket expenses, and because she paid the premiums and costs with after-tax dollars, damages excluding interest should not be subject to tax.

The IRS determined that, for the first policy, to the extent that the damages constitute a return of basis, they are not includible in the Taxpayer's income. With respect to the second policy, because the policy was already surrendered, the IRS determined that the entire amount of the damages attributable to the policy should be included in the Taxpayer's gross income.

Beneficiaries & Trusts

Revenue Ruling 2005-30[121]

Taxpayer A purchased a deferred annuity contract and named Taxpayer B as beneficiary. The contract provided that if Taxpayer A died before the annuity starting date, Taxpayer B would receive a death benefit equal to the account value. Taxpayer A died before the annuity starting date and Taxpayer B received the death benefit under the contract, which exceeded Taxpayer A's investment in the contract.

120. ILM 200504001 (January 28, 2005).
121. Rev. Rul. 2005-30, 2005-20 I.R.B. 1015.

The IRS determined that had Taxpayer A surrendered the contract and received the amounts, those amounts would have been income under Section 72(e) to the extent they exceeded Taxpayer A's investment in the contract. Accordingly, amounts that Taxpayer B receives that exceed Taxpayer A's investment in the contract are income in respect of a decedent under Section 691(a).

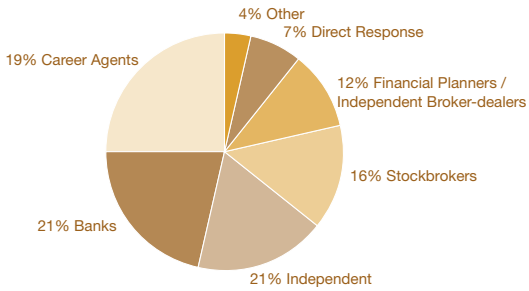
PLR 200518005[122]

Pursuant to the terms of Trust A and Trust B, Taxpayer is to receive the net income of each trust for her life. Upon her death, the principal of each trust is to be divided into equal shares for the benefit of Taxpayer's children. Taxpayer was a co-trustee of the trusts, but she renounced all of her rights as co-trustee in connection with life insurance policies on her life. Life insurance policies on Taxpayer's life were purchased by Trusts A and B using trust corpus after Taxpayer's renunciation.

The IRS ruled that Taxpayer will not possess any incidents of ownership over the life insurance policies held as assets of Trust A and Trust B because Taxpayer renounced her rights as co-trustee and ultimately resigned. Therefore, the proceeds of the life insurance policies will not be included in Taxpayer's gross estate, provided the premiums for the policies are not paid from the income of Trust A or Trust B.

122. PLR 200518005 (May 6, 2005).

Sales of Individual Annuities By
Distribution Channels (1)
2004



1) Preliminary.
2) Financial planner sales included with stockbrokers prior to 2003.

Source: LIMRA International and The Insurance Information Institute —
http://www.iii.org/media/facts/statsbyissue/annuities/

Segregated Asset Accounts

The IRS addressed tax avoidance, diversification requirements, and look-through rules, in the context of segregated asset accounts.

Final Regulations Under Section 817(h)[123]

The IRS released final regulations under Section 817(h) that are designed to limit the use of life insurance and annuity contracts as a way to avoid current taxation of investment earnings. The regulations were originally proposed in 2003.

Under Section 817(h), a variable contract based on a segregated asset account is not treated as an annuity, endowment, or life insurance contract unless the segregated asset account is adequately diversified. Prior to the final regulations, separate regulations applied to registered and non-registered partnerships. The final regulations remove the rule that applies specifically to

123. T.D. 9185, 2005-12 I.R.B. 749.

nonregistered partnerships for purposes of testing diversification. Thus, look-through treatment will be available for interests in a nonregistered partnership if all the beneficial interests in the partnership are held by one or more segregated asset accounts of one or more insurance companies and public access to the partnership is available exclusively (except as otherwise permitted) through the variable contract.

The regulations are effective as of March 1, 2005. However, arrangements in existence on March 1, 2005, will be considered to be adequately diversified if: (a) those arrangements were adequately diversified prior to March 1, 2005, and (b) by December 31, 2005, the arrangements are brought into compliance with the final regulations.

Life / Health Insurance Industry Premium By Line 2003 + 2004

	2003		2004	
Lines of Insurance	Net Premiums written (millions)	Percent of total	Net Premiums written (millions)	Percent of total
Industrial Life	260.1	0.1%	$208.9	(1)
Ordinary Life	97,661.2	19.4	107,506.5	20.1
Ordinary Industrial Annuities	160,910.0	32.0	167,480.2	31.4
Credit Life (Group Industrial)	1,048.4	0.2	1,150.4	0.2
Group Annuities	102,614.4	20.4	104,537.3	19.6
Group Life	25,260.1	5.0	27,727.5	5.2
Accident + Health Group	78,522.4	15.6	85,496.1	16.0
Accident + Health Credit	1,119.4	0.2	1,156.5	0.2
Accident + Health Other	35,745.1	7.1	38,673.5	7.2
Total	503,141.1	100.0	533,936.8	100.0

1) Less than 0.1 percent.

Source: NAIC Annual Statement Database, via National Underwriter Insurance Data Services / Highline Data. Insurance Information Institute — http://www.iii.org/media/facts/statsbyissue/life/

Revenue Ruling 2005-7[124]

The IRS provided guidance as to how, for purposes of determining whether a segregated asset account is adequately diversified under Section 817(h), the look-through rule of Treas. Reg. Section 817(h)(4) applies to an investment in a regulated investment company (RIC) that, in turn, owns an interest in another RIC. The ruling provided needed guidance in the increasingly complex area of separate account products and diversification.

Fund 1 is a RIC and owns shares in Fund 2, also a RIC. Fund 2 comprises greater than 55 percent of the value of the total assets of Fund 1. Except for Fund 1's investment in Fund 2, all the beneficial interests in Fund 1 and Fund 2 are held by one or more segregated asset accounts, and public access to the funds is only available by purchase of a variable contract.

The IRS ruled that under the look-through rule of Section 817(h), the segregated asset account is treated as owning a pro rata portion of each asset of Fund 1, including a pro rata portion of each asset of Fund 2, for purposes of satisfying the diversification requirements of Section 817(h).

Revenue Ruling 2005-31[125]

Rev. Rul. 2005-31 addresses the limitations applicable to dividends received from a regulated investment company.

Taxpayer has elected to be treated as a RIC. Some of Taxpayer's shareholders are United States persons, and some of the shareholders are nonresident alien individuals. Taxpayer's taxable income consists of dividend income (all of which is qualified dividend income within the meaning of Section 1(h)(11)), and interest income (all of which is qualified interest income within the meaning of Section 871(k)(1)), net short-term capital gain and long-term capital gain. Taxpayer distributes a certain amount

124. Rev. Rul. 2005-7, 2005-6 I.R.B. 464.
125. Rev. Rul. 2005-31, 2005-21 I.R.B. 1084.

to its shareholders for the taxable year, of which a portion is received by an individual who is a United States person, and a portion is received by a nonresident alien individual who does not have any effectively connected income.

The IRS concluded that in making the dividend designations permitted by Sections 852, 854(b), and 871(k), a RIC may designate the maximum amount permitted under each provision even if the aggregate of all of the amounts so designated exceeds the total amount of the RIC's dividend distributions. In addition, individual shareholders of the RIC who are United States persons may apply designations to the dividends they receive from the RIC that differ from designations applied by shareholders who are nonresident alien individuals.

PLR 200508002[126]

Following the reasoning set forth in Rev. Rul. 2005-6, the IRS determined that the look-through rule of Treas. Reg. Section 1.817-5(f) applies to a subaccount that invests in an Upper-Tier Fund such that a pro rata share of the assets of any Lower-Tier Fund in which the Upper-Tier Fund invests will be treated as assets of the subaccount for purposes of applying the diversification test.

The assets of Company's separate accounts are allocated among various subaccounts. Each subaccount invests in shares of a particular regulated investment company. The assets of some of these RICs (the Lower-Tier Funds) are comprised of individual securities such as stocks and bonds. Other RICs in which the subaccounts invest (the Upper-Tier Funds) generally do not hold individual securities, but rather hold primarily the shares of Lower-Tier Funds.

The IRS decision that a pro rata portion of each asset of the Lower-Tier Fund will be treated as an asset of each segregated asset account or subaccount that invests in a Lower-Tier Fund

126. PLR 200508002 (February 25, 2005).

was based on the fact that all of the shares of the Lower-Tier Funds will be held by either segregated asset accounts or subaccounts of life insurance companies or Upper-Tier Funds, and public access to the Lower-Tier Funds is available exclusively through the purchase of annuity or life insurance contracts.

Waivers

The IRS issued three rulings regarding the failure of certain life insurance contracts to meet the guideline premium requirements of Sections 101 and 7702. In all three rulings, the IRS waived the failures.

PLR 200528018[127], PLR 200519025[128], and PLR 200525007[129]

In PLR 200528018, the IRS ruled that a remittance payable by a life insurance company to policy owners on the early surrender of their contracts was part of the contracts' cash surrender value and that the company's error in not treating the remittance as part of the cash surrender value could be waived.

In PLR 200519025, Taxpayer, in connection with another matter related to tax administration, began to investigate whether any of Contracts failed to satisfy the applicable requirements of Sections 101(f) and 7702 and determined that various contracts did not satisfy Sections 101(f) and 7702. Taxpayer concluded that the non-compliance of certain of the Contracts resulted from program error and employees' failure to follow Taxpayer's procedures for processing contracts with excess premium payments.

In PLR 200525007, Taxpayer identified a number of contracts as failing to qualify as life insurance contracts under Section 7702(a). Taxpayer used a computerized administration system to monitor the premium payments made under variable universal

127. PLR 200528018 (July 15, 2005).
128. PLR 200519025 (May 13, 2005).
129. PLR 200525007 (June 24, 2005).

life insurance policies to compare the accumulated premiums paid with the guideline premium limitation. When a contract exceeded the guideline premium limitation, the administration system generated a warning message. Taxpayer's employees were to analyze all warning messages; however, several contracts failed to meet the guideline premium limitation, and Taxpayer's employees did not take action. Additionally, Taxpayer's personnel misidentified the Section 7702 failures as Modified Endowment Contracts.

Service Contracts

The IRS continued to rule on the question of whether extended service contracts constitute insurance for Federal tax purposes and whether the issuing company is an insurance company. In the following rulings, the IRS determined that extended service contracts were insurance and that the taxpayer was considered an insurance company.

PLR 200509005[130] and PLR 200525004[131]

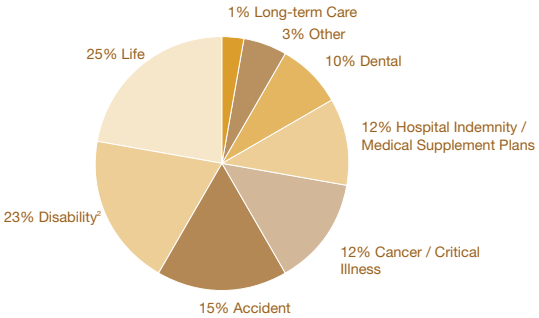
The IRS issued two Private Letter Rulings finding that for Federal income tax purposes, certain vehicle service agreements are insurance contracts and that by accepting a large number of risks, the taxpayers involved had distributed the risk of loss under the service contracts. Further, because more than half of the taxpayers' business is the issuing of service contracts that are insurance contracts, the taxpayers will qualify as insurance companies for purposes of Section 831.

In PLR 200509005, Company was not recognized as an insurance company under the laws of its state of domicile. Company proposed to issue vehicle service agreements (VSAs) that will provide coverage for the mechanical breakdown of certain new and used motor vehicle products which exceeds the coverage of any warranty provided by a manufacturer, or a guaranty or warranty provided by a repairer.

130. PLR 200509005 (March 4, 2005).
131. PLR 200525004 (June 24, 2005).

In PLR 200525004 Company X was the common parent of an affiliated group of corporations that includes companies X, Y, and Automobile Dealers. In connection with Dealers' automotive sales, Dealers offered their customers vehicle service contracts developed and marketed by Taxpayer, a newly formed corporation and a wholly-owned subsidiary of company Y.

Work Site Life Insurance Company
Sales By Line of Business 2004 (1)



1) Worksite marketing is the selling of voluntary (employee-paid) insurance and financial products at the worksite. The products may be on either an individual or group platform and are usually paid through periodic payroll deductions.
2) Short-term and long-term disability.

Source: Eastbridge Consulting Group, Inc. The Insurance Information Institute — http://www.iii.org/media/facts/statsbyissue/life/

Other Product Issues

TAM 200511015[132]

Taxpayer maintains a group medical plan and a self-funded death benefit plan for employees, retired employees and their dependents. Under the Plan, the VEBA purchased life insurance policies on the lives of certain key employees. The life insurance cash values were to accumulate on a deferred tax basis and the tax deferred earnings from the policies would ultimately be paid to the VEBA as tax free benefits. Taxpayer's contributions to the VEBA Trust would be deductible.

132. TAM 200511015 (March 18, 2005).

The examining agent denied Taxpayer's deduction of the annual contributions paid to the VEBA, contending that Taxpayer's control over the VEBA caused the VEBA's investment in life insurance policies to be an investment by *Taxpayer* in life insurance policies.

The IRS determined that, in view of the fiduciary functions performed by Taxpayer, Taxpayer, in exercising control over the VEBA was acting in a fiduciary capacity. To operate the VEBA as a mere conduit for Taxpayer's benefit would violate Taxpayer's duties and obligations under ERISA. Thus, absent some showing of violation of the fiduciary principles, the IRS found no relationship that would equate Taxpayer's contributing amounts to the VEBA to the payment of premiums. Accordingly, the IRS ruled that Taxpayer may deduct the contributions to the VEBA that are used to purchase life insurance policies, the proceeds of which are used by the VEBA to fund certain post-retirement benefits provided by Taxpayer to its employees.

chapter 10

Other

Introduction

In 2003, the IRS announced it would scrutinize the tax-exempt status of entities claiming exemption under Section 501(c)(15) and would challenge the exemption of any entity that did not qualify as an insurance company, regardless of whether the exemption was claimed pursuant to an existing determination letter or on a return filed with the IRS. This year, the IRS made good on its promise, issuing no fewer than twelve Private Letter Rulings related to exemptions under Section 501(c)(15). Most of the rulings were not taxpayer favorable, but the IRS did rule that a VEBA's provision of otherwise unallowable health benefits to adult former dependents of members would not cause the organization to lose its exempt status and that taxpayers who met the transition rule of the Pension Funding Equity Act would not lose their exemption.

The treatment of termination payments continued to trouble retired insurance agents. The IRS litigated four insurance agent cases during 2005 and in each the court determined that termination payments were ordinary income, not long-term capital gains.

Mutual insurance companies finally saw the differential earnings amount disappear. Since its inception in the Deficit Reduction Act of 1984[133] controversy has arisen over the differential earnings amount. Several companies litigated over the denial of a negative differential earnings amount, and the IRS won in each case. The IRS this year released what should be its last publication of the differential earnings rate.

133. Deficit Reduction Act of 1984. Pub. L. No. 98-369.

Exempt Organizations

In the last several years concerns around perceived abuses of the benefits afforded by 501(c)(15) prompted a change in the law to make obtaining exempt status more onerous. Coincident with that was a reaffirmation that the provision is available to "insurance" companies only and that the IRS will be more rigorous in its analysis and audit of "insurance" company status. The following rulings are a result of these actions.

PLR 200520035[134]

Company O, a wholly owned subsidiary of P, is a Federally regulated bank. P established a company (N) in a foreign jurisdiction to reinsure risks. N elected under Section 953(d) to be treated as a domestic corporation. N applied for and received exemption as an organization described in Section 501(c)(15).

Subsequently, the IRS examined N's transactions and determined that there was no evidence that N's capital and efforts were devoted primarily to the "insurance" business. N's assumed coverage depended upon the efforts of O to sell policies; O's only effort was to solicit seven of its employees. N's capital was also substantially disproportionate to the risks undertaken: the premium income and "loss reserves" were insignificant compared to the value of the financial interests it held.

The IRS concluded that N was not an insurance company for Federal income tax purposes. The IRS further concluded that were N a domestic corporation, it would not have qualified as an insurance company for the year involved, and therefore was ineligible to make the election under Section 953(d). Because N was not an insurance company, N did not qualify for recognition of exemption from Federal income tax under Section 501(c)(15) and its exemption should be revoked.

134. PLR 200520035 (May 20, 2005).

PLR 200528027[135] and PLR 200552021[136]

In two substantially identical rulings, the IRS determined that insolvent insurance companies were exempt from Federal income taxation.

Insurance Company is an insolvent insurance company being liquidated under the supervision and control of the court-appointed statutory Receiver. Insurance Company was exempt from Federal income tax under Section 501(c)(15) for years when Insurance Company's policy claims exceed its reserves, and when Insurance Company's net written premiums (or if greater, direct written premiums) did not exceed the $350,000 limit under Section 501(c)(15).

Section 206 of the Pension Funding Equity Act[137] (PFE) amended Section 501(c)(15) to provide for the exemption of insurance companies if (1) the gross receipts for the taxable year do not exceed $600,000, and (2) more than 50% percent of such gross receipts consist of premiums. The PFE provided a special transition rule for insurance companies in receivership or liquidation.

Because more than 50% of its gross receipts did not consist of premiums, Insurance Company did not meet the new requirements of amended Section 501(c)(15)(A). However, the IRS determined that Insurance Company met the requirements of the transition rule. As a result, the amendments to Section 501(c)(15) would not apply until taxable years beginning after the earlier of the date Insurance Company's liquidation ends or December 31, 2007, and Insurance Company would continue to be exempt under Section 501(a).

These rulings are important because the IRS ruled that an insurance company in receivership, issuing no new policies, is deemed an insurance company. While this is the logical answer, there has been a debate as to whether a company which was

135. PLR 200528027 (July 15, 2005).
136. PLR 200552021 (December 30, 2005).
137. Pension Funding Equity Act of 2004, Pub. L. 108-218.

simply in the process of winding up insurance business in run-off, but not currently issuing contracts, still qualified as an insurance company for purposes of this provision.

PLR 200529008[138]

A company that does not qualify as an insurance company for Federal income tax purposes is not exempt under Section 501(c)(15). While the PLR was heavily redacted, the IRS stated its intent to publish more of the ruling at a later date.

The IRS determined that because there was only one insured, Company's insurance arrangement did not qualify as insurance for Federal income tax purposes because there was no risk distribution. Because the arrangement did not qualify as insurance for Federal income tax purposes, Company did not qualify as an insurance company for 2003 and 2004.

PLRs 200531019[139], 200531022[140], 200531023[141], 200531028[142], 200545051[143], 200545052[144], 200550044[145], and 200550045[146]

The IRS released eight similar rulings, revoking organizations' tax-exempt status under Section 501(c)(15) because they failed to qualify as insurance companies as defined under that provision.

In each ruling the IRS explained that its decision was outlined in an examination report enclosed with the ruling, which further explained why the IRS believed an adjustment of the taxpayers' exempt status was necessary. Each taxpayer was required to file Federal income tax returns for the tax period affected, for all years still open under the statute of limitations, and for all later years. Each ruling contained instructions on contesting the revocation of exempt status.

For three of the taxpayers, the IRS addressed Section 953(d) issues related to the exemption rulings.

138. PLR 200529008 (July 22, 2005).
139. PLR 200531019 (August 5, 2005).
140. PLR 200531022 (August 5, 2005).
141. PLR 200531023 (August 5, 2005).
142. PLR 200531028 (August 5, 2005).
143. PLR 200545051 (November 10, 2005).
144. PLR 200545052 (November 10, 2005).
145. PLR 200550044 (December 16, 2005).
146. PLR 200550045 (December 16, 2005).

PLR 200537036[147]

Taxpayer is a tax-exempt entity under Section 501(c)(9) which provides various group life insurance and health insurance to its members through group policies.

Taxpayer intends to have Corporation M, a wholly-owned for-profit subsidiary, make the same type of insurance benefits that it provides to its members available to adult former dependents of members and individuals who retired before becoming eligible for retirement benefits. Taxpayer intends to create a new voting membership category for the two groups and to cover them under the same group policy that currently covers its other members.

The IRS ruled in two areas: (1) That individuals who terminated employment before becoming eligible for retirement benefits are "employees" within the meaning of Section 1.501(c)(9)-2(b)(2) and (2) That the use of M Corporation to administer that portion of group insurance policies that covers the adult former dependents of members does not constitute the provision of more than a de minimis amount of unpermitted benefits under Section 1.501(c)(9)-3(a). Consequently, Taxpayer's provision of otherwise unallowable health benefits to adult former dependents of members will not cause the organization to lose its exempt status.

The IRS has ruled favorably on several VEBA matters this year, including TAM 200511015.

147. PLR 200537036 (September 16, 2005).

A detailed insurance industry income statement for the first nine months of 2005.	
	$ in billions
Earned Premiums	309.9
Incurred Losses (Including loss adjustment expenses)	229.6
Expenses	82.3
Policyholder Dividends	0.8
Net Underwriting Gain (Loss)	-2.8
Investment Income	36.4
Other Items	0.7
Operating Gain	34.3
Realized Capital Gains/Losses	4.3
Pre-tax Income	38.6
Taxes	-9.8
Net After-Tax Income	28.8
Surplus (End of Period)	414.3
Combined Ratio	100.0
*Figures may not add to totals due to rounding. Calculations in text are based on unrounded figures.	

Sources: Insurance Services Office, Property Casualty Insurers Association of America and the Insurance Information Institute Online — http://www.iii.org/media/industry/financials/2005firstninemonths/

Agent Issues

The Courts have continued to rule consistently that insurance agent termination payments are ordinary income and that renewal commission income is subject to self-employment tax. In the cases following, the Courts also ruled that the goodwill of an insurance business is its policy records and policyholder information, which are owned by the insurance company, not the agent.

Trantina v. United States[148]

The U.S. District Court ruled in Charles E. Trantina et ux. v. United States that an agent's termination payments are ordinary income and not long-term capital gains.

148. Trantina v. U.S., WL 1624889 (D. Ariz., 2005).

Charles Trantina, an independent insurance agent of State Farm Life Insurance Companies, executed a Corporation Agent Agreement between Trantina's Corporation, Trantina Insurance Agency and State Farm. When Trantina retired, he terminated the Corporate Agreement and exchanged his stock for all of the assets owned by the Corporation, including the right to collect termination payments.

Trantina first reported the termination payments received from State Farm as ordinary income but then amended his returns to report the payments as long-term capital gains. The IRS accepted two of the amended returns but denied Trantina's claim for a refund on a third. Trantina filed a suit in District Court, maintaining that he was entitled to classify the termination payments as long-term capital gains under Section 1222(3) as a result of the termination of the Corporate Agreement, which he termed a "sale" of the agency back to State Farm.

The District Court determined that the termination payments did not qualify as long-term capital gains because Trantina (1) possessed no capital assets to sell, and (2) the Corporate Agreement was not sold or exchanged in consideration of the termination payments.

Garza v. Commissioner[149]

Mario Garza was an insurance agent with American Life. When Garza left American Life, he continued earning commissions on all policy renewals in his accounts even though he was no longer working for American Life. However, during his employment, Garza had received advances against future commissions and had certain expenses paid for by American Life that amounted to almost $90,000; therefore, following his retirement, all commissions creditable to Garza were applied to the liquidation of his outstanding account balances.

149. Garza v. Commissioner of Internal Revenue, T.C. Summ.Op. 2005-96 (2005).

American Life issued Forms 1099-MISC, *Miscellaneous Income*, for these amounts but Garza did not report the income on his tax returns. The IRS issued a notice of deficiency which Garza appealed.

The Court ruled that when American Life applied the renewal commissions to Garza's outstanding account balances, his obligation to repay the loans was reduced by those amounts, and the reduction of his obligations constituted his receipt of taxable income. Therefore, Garza received commission income. Further, because Garza received commissions on the renewal of policies that he wrote while he was an active agent, he earned commission income subject to self-employment tax.

The Court also applied a penalty for the substantial understatement of tax because the amount of the understatement exceeded 10 percent of the tax required to be shown on the return.

Gregg Gilbert v. Commissioner[150]

Gregg Gilbert (Gilbert) worked as an insurance agent for Capitol American Life Insurance Company, now known as Conseco Health Insurance Company (Conseco). Gilbert received renewal commission compensation throughout his employment with Conseco.

In 1999 Gilbert suffered a disabling accident which forced him to retire, and Gilbert's Marketing Agreement with Conseco was officially terminated. Gilbert did not sign a separate termination agreement and continued to receive commission compensation from renewal policies with Conseco.

On their Form 1040, *U.S. Individual Income Tax Return*, the Gilberts reported the renewal commissions as "Other Income," and labeled this income as "Insurance Renewal Commissions." The IRS issued a notice of deficiency, which stated that Gilbert was liable for self-employment taxes.

150. Gilbert v. Commissioner of Internal Revenue, T.C. Summ. Op. 2005-176 (2005)

The Tax Court determined that the renewal commission payments were not exempted from self-employment tax. Further, the Tax Court pointed out that the renewal commission payments were disbursed not pursuant to a termination agreement but per the Marketing Agreement, without regard to whether Gilbert was still employed by Conseco. Gilbert was subject to self-employment tax on the payments he received after his termination, just as he was on the renewal commissions he received during his employment.

David E. Jones v. Commissioner[151]

David E Jones worked for State Farm Insurance from 1959 until his retirement in 1996. At retirement, all of Jones' policies were assigned to a successor agent who purchased the office building and personal property formerly owned by Jones. The purchase agreement entered into between Jones and the successor covered only the building and its furnishings and made no mention of goodwill or the purchase of Jones' insurance business.

Jones received termination payments from State Farm which he reported as ordinary income. He later amended his returns to characterize the payments as long-term capital gains. Although the payments themselves came from State Farm, Jones argued that State Farm was merely the conduit for payments from the successor, who actually purchased these intangible assets.

The District Court found that Jones' theory failed because there was no evidence that the termination payments were consideration from the successor, and Jones did not own the intangible assets he purported to have sold.

151. Jones v. U.S., 355 F. Supp. 2d 1292 (S.D. Ala., 2004).

Mutuals

During 2005, mutual insurance companies continued to be affected by the changes in computation of the differential earnings amount and recomputed differential earnings amount.

The Job Creation and Worker Assistance Act of 2002[152] amended Section 809 by adding new Section 809(j), which provided that the differential earnings rate would be treated as zero for purposes of computing both the differential earnings amount and the recomputed differential earnings amount for a mutual life insurance company's taxable years beginning in 2001, 2002, or 2003.

Because of the addition of Section 809(j), there was no need to determine a tentative recomputed differential earnings rate for 2003. The final recomputed differential earnings rate for 2003 was already determined to be zero.

Subsequent to the Job Creation and Worker Assistance Act, the Pension Funding Equity Act of 2004[153] repealed Section 809 *for taxable years beginning after December 31, 2004*. Therefore, the IRS was required only to determine a tentative differential earnings rate for 2004.

Notice 2005-18[154]

The IRS published a tentative determination under Section 809 of the "differential earnings rate" for 2004.

152. Job Creation and Worker Assistance Act of 2002, Pub. L. 107-147.
153. Pension Funding Equity Act of 2004, Pub. L. 108-218.
154. Notice 2005-18, 2005-9 I.R.B. 634.

Tentative Determination of Rates To Be Used For Taxable Years Beginning in 2004

Differential earnings rate for 2004	0
Imputed earnings rate for 2004	4.449
Base period stock earnings rate	18.221
Current stock earnings rate for 2004	4.913
Stock earnings rate for 2001	2.354
Stock earnings rate for 2002	-1.876
Stock earnings rate for 2003	14.261
Average mutual earnings rate for 2002	5.570

Rev. Rul. 2005-58[155]

The IRS published the final determination under Section 809 of the "differential earnings rate" for 2004.

Determination of Rates To Be Used For Taxable Years Beginning in 2004

Differential earnings rate for 2004	0
Recomputed differential earnings rate for 2003	0
Imputed earnings rate for 2004	4.449
Base period stock earnings rate	8.221
Current stock earnings rate for 2004	4.913
Stock earnings rate for 2001	2.354
Stock earnings rate for 2002	-1.876
Stock earnings rate for 2003	14.261
Average mutual earnings rate for 2002	5.570

155. Rev. Rul. 2005-58, 2005-36 I.R.B. 465.

Dividends Received Deduction

The U.S. District Court ruled in favor of OBH, Inc. (Berkshire or Taxpayer) in a dividends-received deduction (DRD) controversy implicating the debt financing rules of Section 246A[156].

In the mid-1980s, National Indemnity Insurance Co. (NICO), a Berkshire subsidiary, borrowed $750 million. Berkshire placed the $750 million loan proceeds into NICO's main operating account. Over two years, an additional $2.3 billion was deposited into that account from various sources. NICO made daily allocation decisions as to where the money was invested.

The Court's decision notes that an IRS agent read an article in *Forbes* magazine that theorized that Berkshire was claiming the full DRD notwithstanding that it used the debt proceeds to acquire its stock positions. The agent analyzed the issue, and the IRS sought to scale back the DRD claimed by NICO under Section 246A.

The Court held that: 1) Berkshire's dominant purpose in incurring debt was not to acquire dividend-paying stock; 2) the debt transactions were not directly traceable to its acquisition of dividend-paying stock; and 3) the fact that NICO had not paid off intra-company debt to Berkshire at the time of the debt offering did not preclude the DRD. Accordingly, the Court concluded that the IRS erroneously applied Section 246A.

The Court was cognizant of the fact that Section 246A's current statutory and regulatory regime makes it virtually impossible for the IRS to trace debt proceeds and thus assess tax deficiencies under Section 246A against companies like Berkshire who engage in numerous investment transactions. Taxpayers with potential Section 246A exposure should be on the lookout for regulations which may be issued in the future requiring a pro rata allocation rule to determine the use of borrowings that are not traceable to a specific use. Such regulations may result in smaller DRDs.

156. OBH, Inc. v. United States, 397 F.Supp.2d 1148 (D. Neb., 2005).

Information Reporting

Temporary Regulations Under Section 6033[157]

The IRS issued temporary and proposed regulations requiring certain large corporations and tax–exempt organizations to electronically file their income tax or annual information returns. The electronic filing requirements only apply to entities that file at least 250 returns, including income tax, excise tax, information, and employment tax returns, during a calendar year.

For taxable years ending on or after December 31, 2005, the temporary regulations require that corporations with total assets of $50 million or more file their Forms 1120 or 1120S electronically. The electronic filing requirement will be expanded to include taxable years ending on or after December 31, 2006 for various other corporations and tax–exempt organizations.

As the asset thresholds for required electronic filing drop substantially for tax years after December 31, 2006, it appears that most corporations will be required to file electronically for tax year 2007. This is a perfect time for taxpayers to review their compliance process for “hand processing” and make sure they will be able to file a complete and accurate return electronically.

Corporate e-filing

Corporations that have assets of $50 million or more and file at least 250 returns annually are required to electronically file their 1120/1120S income tax returns for tax years ending on or after December 31, 2005. After the first effective year, the requirement will affect corporations that have assets of $10 million or more and file at least 250 returns annually. Others may voluntarily convert to electronic filing.

157. T.D. 9175, 2005-10 I.R.B. 665.

The IRS website has detailed instructions for taxpayers required to e-file for the 2005 tax year. In particular, the IRS website contains instructions for forms allowed as PDF files, transactional data, international forms, and forms not required to be filed with the return.

PDF Files:

Certain limits apply to returns e-filed in PDF format, including:

- No one PDF file size can exceed 50 Mb (approximately 500 pages).
- Multiple PDF files may be submitted but each PDF file must be less than 50Mb.
- A separate file must be created for each form type included as PDF.

For corporations that file a consolidated Form 1120 and have life insurance and/or property and casualty insurance subsidiaries, the entire return must be filed electronically with the exception of the Forms 1120-L and 1120-PC subsidiary returns, which must be attached as PDF files.

Transactional Data:

Summary format can be used when the underlying transactional data contains more than 100 lines for that particular data type. The summary totals must be reported by data type, classification, or other grouping as required on the form. If there are less than 100 instances of transactions by data type, classification, or other grouping the transactions are required to be itemized. Affected forms include Form 4562 Depreciation and Amortization, Form 4797 Sale of Business Property, and Schedule D Capital Gains and Losses.

International Forms:

If a corporation is required to file 25 or more of certain international forms, IRS has provided a paper option that can be used for filing those forms.

Forms not Required to be Filed with the Return:

Corporations should not send these forms as part of the electronic return: Form 966, Affiliations Schedule, Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return, Form 8023, Election Under Section 338(g) for Corporate Qualified Stock Purchases, and Form 8693, Low Income Housing Credit Disposition Bond.

Further details can be obtained from the IRS website. The website also contains information on how to request a waiver from required e-filing for corporations that cannot meet electronic filing requirements due to technology constraints, or where e-filing would result in undue financial burden.

Automatic Extensions[158]

The IRS issued temporary and proposed regulations under Section 6081 that permit most individual and business taxpayers to request an automatic, six-month extension of time to file certain tax returns. Beginning January 1, 2006, most individuals and businesses will be able to request a six-month extension without a reason or even a signature.

Corporate and Non-corporate Businesses: The temporary regulations do not change the rules regarding filing extensions for corporate income tax returns. Taxpayers that previously requested additional time to file certain excise, income, information, partnership, trust, and other returns by submitting Form 2758 may request an automatic six-month extension of time to file by filing the new Form 7004. Forms 2758, 8736, and 8800 have been eliminated.

158. T.D. 9229, 2005-48, I.R.B.1051.

Employee plans: The temporary regulations allow administrators and sponsors of employee benefit plans subject to ERISA to report information concerning the plans on a new version of Form 5558 for an automatic two and one-half-month extension of time to file.

Estimated Tax Payments[159]

The IRS issued proposed regulations under Section 6655 that provide guidance for corporations to compute their estimated tax liabilities. The proposed regulations replace existing proposed regulations that were issued in 1984 and did not reflect significant changes to the tax law, most notably the enactment of the economic performance rules under Section 461(h). As a result, the IRS and Treasury Department have become aware of techniques employed by some firms, particularly those computing their estimated tax payments using an annualization method, that reduce, if not eliminate, estimated tax payments for one or more installments for a taxable year.

The current re-proposed regulations provide extensive guidance on how to determine the amount due with each quarterly installment, whether based on the corporation's estimated annual tax liability, or the corporation's annualized or adjusted seasonal taxable income. The proposed regulations also provide rules for computing estimated tax during short taxable years.

This is another example of the IRS tightening rules which they believe have been manipulated by taxpayers. Corporate taxpayers should assess the impact of these proposed regulations on their quarterly estimated tax payment calculations to determine whether their accounting policies with regard to certain items of income and deduction need to be revised.

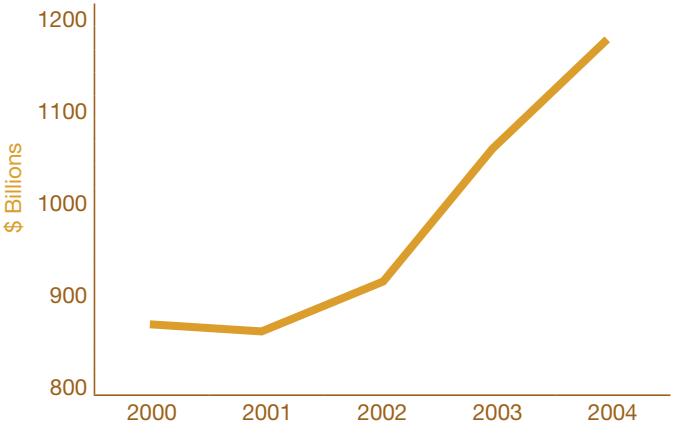
159. T.D. 9229, 2005-48, I.R.B. 1051.

Miscellaneous Insurance Tax Developments

In a year of natural disasters, it is not surprising that several of the developments during the year were related in some way to dealing with financial losses. During the year companies were reminded of the benefits of utilizing the abnormal loss rules under Section 832(c)(5); the IRS clarified the requirements of qualification for specified liability losses; and the IRS released a TAM relating to state guarantee fund assessments for natural disasters.

Other developments included a reciprocal's revocation of its Section 835 election and a Private Letter Ruling in which a taxpayer providing workers' compensation insurance was found to be an insurance company.

Property / Casualty Insurer Financial Assets 2000 – 2004



Source: The Insurance Information Institute — http://www.iii.org/media/facts/statsbyissue/industry/

Abnormal Loss Rules

Given the fact that many non-life insurance companies sold off securities to pay significant claims during 2005, companies may wish to consider, or re-consider, the benefits of utilizing the abnormal loss rules under Section 832(c)(5).

The general rule under Section 1211(a) is that a corporation can deduct its capital losses only to the extent of its capital gains and cannot offset a net capital loss against ordinary income. However, Section 832(c)(5) provides limited relief from this general rule by permitting an insurance company to treat losses with respect to sales or exchanges of capital assets which, in accordance with the statute's quantitative test, are considered to be made for the purpose of obtaining funds to pay abnormal insurance losses as a deduction from ordinary income, rather than becoming a net capital loss carryback and carryover under Section 1212(a).

The IRS's interpretation and explanation of this favorable tax provision under differing factual circumstances may be obtained by consulting FSA 200120004[160], GCM 39419[161], and GCM 32642[162].

160. FSA 200120004 (May 18, 2001).
161. GCM 39419 (October 10, 1985).
162. GCM 32642 (August 12, 1963).

Notice 2005-20[163]

The IRS has litigated several cases since the enactment of the Tax Trade Relief Extension Act of 1998, which dealt with the definition of a specified liability loss. In Notice 2005-20, the IRS outlined the rulings in *Sealy Corp. v. Commissioner*[164], *Host Marriott Corp. v. United States*[165], and *Major Paint Co. v. United States*[166]. In each of these cases, the courts determined whether the companies' liabilities met the requirements necessary to qualify as specified liability losses. The Notice provides answers to the following questions that address the requirements of qualification for specified liability losses:

1. What tests must a liability satisfy to "arise under Federal or state law"?
2. May a tort liability satisfy the requirements of former Section 172(f)(1)(B)(i)?
3. What is a tort liability that arises "out of a series of actions (or failures to act) over an extended period of time"?
4. Which act in the chain of causation leading to the creation of a liability constitutes "the act or failure to act" giving rise to that liability?
5. Does a deduction allowable "with respect to" a liability include other items, such as legal and professional fees to contest the liability or court costs incurred to litigate the liability?
6. Are depreciation deductions allowable with respect to the liability giving rise to the depreciable basis of a depreciable asset?

163. Notice 2005-20, 2005-9 I.R.B. 635.
164. Sealy Corp. v. Commissioner, 107 T. C. 177 (1996), aff'd, 171 F.3d 655 (9th Cir. 1999).
165. Host Marriott Corp. v. United States, 113 F. Supp. 2d 790 (D. Md. 2000), aff'd, 267 F.3d 363 (4th Cir. 2001).
166. Major Paint Co. v. United States, 334 F.3d 1042 (Fed. Cir. 2003).

TAM 200517030[167]

Taxpayer is an insurance company that provides homeowners insurance. The state at issue requires all private insurance companies within the state that offer Type X insurance to offer purchasers the opportunity to buy coverage against damage caused by an Event. The State controls a Fund which underwrites and issues Event insurance policies in its own name. Insurers that offer Type X insurance can meet their legal obligation to offer Event coverage by participating in the Fund. Premiums collected by the Fund are exempt from the state's premium tax and Federal income tax.

Taxpayer is a Participating Insurer in the Fund. To participate in the Fund, Participating Insurers are required to contribute an initial assessment to the Fund. Taxpayer deducted its assessment on its Federal income tax returns for the years at issue.

The IRS determined that "Taxpayer's payment of the initial assessment to the Fund permits it to limit its projected liability that it would otherwise be subject to as the direct issuer of Event insurance policies; however, this benefit is more in the nature of a reduction of future expenses, which, in itself, is not a benefit generally requiring capitalization." The initial assessment is therefore deductible as an ordinary and necessary business expense.

The instant facts differ from a typical guarantee fund assessment in that no premium tax credit was offered by the state. Also, the Taxpayer was satisfying its legal obligation to offer Event coverage by joining the Insurance Fund. Therefore, the payments to this fund were distinguishable from payments to guarantee funds that operate to satisfy the obligations of insolvent insurers. Furthermore, it is interesting to note that the IRS did not refer to the guidance contained in Revenue Procedure 2002-46, related to the safe harbor for premium acquisition expenses.

167. TAM 200517030 (April 29, 2005).

PLR 200531001[168]

Reciprocal writes medical professional liability insurance. Since Reciprocal's inception, its Attorney in Fact (AIF) has been Reciprocal's exclusive manager. Reciprocal made an election under Section 835 to be subject to the limitation provided in Section 835(b), but then sought to revoke the election.

Reciprocal's taxable income for the year at issue included both income earned by Reciprocal, as well as income from AIF attributed to Reciprocal under Section 835(b). Because AIF's parent paid no tax, Reciprocal did not get a credit under Section 835(d) to reduce its tax liability. Consequently, Reciprocal's tax liability due to its Section 835 election was significantly greater than it would have been had Reciprocal not computed its taxes under that Section.

The IRS determined that such a result was not intended for elections under Section 835 and granted consent to revoke the election.

The General Accounting Office told Congress that a loose law allows risk retention groups to operate in ways that do not always protect their solvency and the best interest of insureds. In a report on the nation's rapidly growing RRG sector – which number nearly 200 – the GAO said common regulatory standards and greater protections for group members are needed as most operate from six states where there is minimal control and there is a risk they could go insolvent… It found that some insurance regulators believe members… will have less interest in the success and operation of their RRG, and that RRGs would be chartered for purposes other than self-insurance – such as making profits for entrepreneurs who form and finance them.

Source: Daniel Hays, "GAO: Put a Leash on RRGs," National Underwriter Property & Casualty-Risk & Benefits Management Edition, September 26, 2005.

168. PLR 200531001 (August 5, 2005).

PLR 200538012[169]

In order to provide workers' compensation benefits for independent contractors (Operators) of a certain industry who were not covered by workers' compensation insurance, State revised its workers' compensation laws and created Taxpayer as a not-for-profit corporation to administer and pay workers' compensation benefits to Operators. Each contractor doing business within State is required to be a member of Taxpayer.

Taxpayer requested a ruling that it is taxable as an insurance company other than a life insurance company under Section 831.

In coming to its conclusion, the IRS determined that the risk of loss is the Operators', not contractors' or Taxpayer's; however, the risk of loss was an insurance risk. The IRS stated that "this risk is shifted from Operators to Taxpayer and distributed across the many similarly situated Operators. Therefore, the arrangement constitutes insurance for Federal income tax purposes and Taxpayer will be an insurance company within the meaning of Section 831(c) for each taxable year that this arrangement is more than half of its business."

General Corporate Issues

In addition to the many insurance-specific developments during 2005, the IRS also issued regulations and other reports of interest to insurance companies. Final regulations under Section 179 adopted changes to property placed in service after 2002 and before 2008. The IRS clarified the deductible amount of trade or business expenses for use of a business aircraft for entertainment. And, the Government Accountability Office (GAO) issued a report to the Committee on Finance, U.S. Senate pursuant to a request by the Congress to review some of the largest settlement agreements and determine how companies have treated their civil settlement payments for Federal tax purposes.

169. PLR 200538012 (September 23, 2005).

Final Section 179 Regulations[170]

The IRS issued final regulations relating to the election to expense the cost of property subject to Section 179. The regulations reflect changes to the law made by the Jobs and Growth Tax Relief Reconciliation Act of 2003[171] (JGTRRA) and the American Jobs Creation Act of 2004[172] (AJCA).

The final regulations adopt the rules relating to the JGTTRA changes contained in the temporary and proposed regulations published August 4, 2004 and also apply the AJCA's two-year extension of the JGTTRA changes to Section 179 property placed in service by a taxpayer in a taxable year beginning after 2002 and before 2008.

Notice 2005-45[173]

The IRS released interim guidance on the limitation under Section 274(e) on the deductible amount of trade or business expenses for use of a business aircraft for entertainment. Many companies have seen the use of the corporate aircraft audited in recent years, and this issue in particular. The IRS clearly hoped to clarify its position through this notice.

GAO Report[174]

The United States Government Accountability Office (GAO) issued a report to the Committee on Finance, U.S. Senate pursuant to a request by the Congress to review some of the largest settlement agreements and determine how companies have treated their civil settlement payments for Federal tax purposes.

Companies currently undergoing civil settlements with a Federal agency should consider what, if any, impact the GAO report will have on any settlement negotiations. That is, a company may wish to specifically address the character of any payments it may make under a civil settlement with an agency and consider

170. T.D. 9029, 2005-31 I.R.B. 153.
171. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. 108-27.
172. American Jobs Creation Act of 2004, Pub. L. 108-357.
173. Notice 2005-45, 2005-24 I.R.B. 1228.
174. GAO-05-747.

the appropriate language to use when negotiating settlement agreements with the Federal Government.

The GAO recommended that the IRS work with agencies to develop a cost-effective means of systematically obtaining information on civil settlements that would benefit the IRS in ensuring the correct tax treatment of settlement payments. The IRS agreed with the GAO recommendation and will form an executive-led team to implement such recommendation.

The Tax Trade Relief Act of 2005, S. 2020, contains provisions that would deny deductions for certain fines, penalties, and punitive damages. The bill provides in part:

"No deduction otherwise allowable shall be allowed under this chapter for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law."

and

"No deduction shall be allowed under this chapter for any amount paid or incurred for punitive damages in connection with any judgment in, or settlement of, any action."

Certain exceptions could apply. S. 2020 passed the Senate and is expected to be reconciled with H.R. 4297 sometime during 2006.

Multistate

chapter 11

Multistate Insurance Taxation

While the 2005 legislative session did not produce much actual signed legislation of note, there were several interesting proposed bills that are worth mentioning. Four states, West Virginia, Texas, Massachusetts and Montana, proposed legislation that would have required any "non-insurance" income generated by an insurance company to be subject to that state's corporate income tax. While none of the legislation passed it is an interesting and concerning development. Along the same lines, the Multistate Tax Commission (MTC) has issued a draft unitary statute that would leave it up to the discretion of the state tax commissioner whether to include insurance companies in a unitary return. In order for the draft statute to become law, each member state's legislature will have to approve it.

Some of the more substantive changes at the legislative level include a decrease in the premium tax rate for life premium in Minnesota, a new CoverColorado credit in Colorado to replace the repealed CAPCO credit, a change to the salary credit in Florida as well as a clarification of the statute of limitations, a new investment credit in Iowa, a new interim assessment on HMOs in New Jersey, a new CAPCO Five program starting in New York, an increase in the premium tax rate for HMOs in North Carolina, and a new venture capital credit in South Carolina. In addition, the Puerto Rico legislature passed a new premium tax rate of 6% up from 4% for all premiums except annuity which increased from 1% to 3%. Note that the new rates will not go into effect until ratified.

.On the judicial and audit side, the Michigan Court of Claims found that Michigan's practice of not reflecting SBT credits in retaliatory tax was discriminatory in that it denied credits to foreign companies. The Pennsylvania Commonwealth Court found that the New Jersey second injury fund assessment is equivalent to a license fee and is the burden of the insurer and thus should be in the New Jersey side of the retaliatory tax

computation. Further the New Jersey Appellate Division held that New Jersey's practice of reflecting a 12.5% premium tax cap in its retaliatory tax calculation was contrary to legislative intent and violated the Equal Protection Clause.

State-by-State Developments

Alaska

Senate Bill 101 made a technical correction to the surplus lines tax providing that the tax is on premium, not premium receipts.

Arizona

House Bill 2190 decreased the surplus lines broker's license fee from $1,800 to $1,000. It also provided that surplus lines insurance must be placed through an Arizona licensed surplus lines broker.

Arkansas

Senate Bill 368 required the worker's compensation tax to be paid and assessed in the same manner as the insurance premium tax.

House Bill 2900 repealed the existing retaliatory tax statute and replaces it with a new retaliatory tax on the taxes, licenses, and other fees and the same fines, penalties, deposit requirements or other material requirements, obligations, prohibitions or restrictions that are imposed upon the insurance company, its agents or representatives by the laws of another state. The new law excludes application fees, examination fees, license fees, appointment fees and consultation fess for agents, adjusters, service representatives or consultants. Further, the bill excluded foreign insurance companies from the retaliatory tax if more than 15% of the company's capital stock is owned by a corporation organized and domiciled in Arkansas.

Premium Taxes By State, Property / Casualty, Life / Health Insurance 2004 ($000)

Insurance companies, including life / health and property / casualty companies, paid $13.8 billion in premium taxes to the 50 states in 2004. On a per capita basis, this works out to $47 for every person living in the United States.

State	Amount	State	Amount
Alabama	$ 245,577	Montana	$ 61,063
Alaska	49,873	Nebraska	38,460
Arizona	312,582	Nevada	194,228
Arkansas	91,330	New Hampshire	79,450
California	2,114,980	New Jersey	417,873
Colorado	177,782	New Mexico	87,448
Connecticut	218,202	New York	833,073
Delaware	68,009	North Carolina	432,975
Florida	573,100	North Dakota	30,928
Georgia	317,463	Ohio	423,078
Hawaii	81,916	Oklahoma	144,186
Idaho	82,283	Oregon	52,167
Illinois	378,517	Pennsylvania	639,578
Indiana	178,303	Rhode Island	43,350
Iowa	138,229	South Carolina	106,643
Kansas	121,827	South Dakota	55,339
Kentucky	331,903	Tennessee	351,111
Louisiana	342,353	Texas	1,130,499
Maine	77,770	Utah	105,965
Maryland	279,089	Vermont	49,018
Massachusetts	399,764	Virginia	351,278
Michigan	230,272	Washington	345,614
Minnesota	265,970	West Virginia	102,181
Mississippi	161,201	Wisconsin	138,388
Missouri	304,848	Wyoming	18,034
		Countrywide	13,775,340[1]

1) Does not add due to rounding.

Source: The Insurance Information Institute Fact Book 2006, Insurance Information Institute, 2006, page 30.

House Bill 2900 repealed the existing retaliatory tax statute and replaces it with a new retaliatory tax on the taxes, licenses, and other fees and the same fines, penalties, deposit requirements or other material requirements, obligations, prohibitions or restrictions that are imposed upon the insurance company, its agents or representatives by the laws of another state. The new law excludes application fees, examination fees, license fees, appointment fees and consultation fess for agents, adjusters, service representatives or consultants. Further, the bill excluded foreign insurance companies from the retaliatory tax if more than 15% of the company's capital stock is owned by a corporation organized and domiciled in Arkansas.

Senate Bill 1031 amended the CAPCO provisions to provide that if the company requests a transfer of credits and has not heard from the governing board within 15 days, the transfer is approved.

Senate Bill 1136 repealed the comprehensive Health Insurance Pool annual assessment limitation which was .01% of the total written premium on business in the state.

Senate Bill 369 repealed the provisions requiring companies insuring motor vehicles to file a report showing the total premium collected on collision, comprehensive and liability insurance as well as the amount of premium tax paid on such policies.

California

Assembly Bill 1424 provided that the tax levied upon an insurer is a lien upon all property and franchise of every kind and nature belonging to the insurer.

Colorado

House Bill 1060 allowed a premium tax credit for tax years 2005 through 2014 for insurers making contributions to CoverColorado plans. The transferable credit would not be recaptured through retaliatory tax and would equal 103% of investment.

House Bill 1161 created an Immunization Tracking Fund in the Department of Public Health and Environment and would allow a credit to insurers against premium tax for cash contributions to the fund.

House Bill 407 provided that the Insurers Insolvency Pool assessment may not be taken into account when calculating rates.

Connecticut

House Bill 6807 waived the $25 Application for Agent Appointment fee and $20 Agent Appointment issuance fee for insurers domiciled in a state or foreign country which will offer reciprocal waiver to Connecticut insurers.

Senate Bill 1351 provided that the retaliatory tax does not apply to ad valorem taxes on real or personal property, personal income taxes, fees for agents' licenses, special purpose assessments imposed in connection with particular kinds of insurance including, but not limited to, workers' compensation assessments and Insurance Guaranty Association Fund assessments or to premium taxes on special health care plans except where another state or foreign country imposes upon Connecticut domiciled insurers retaliatory charges for such taxes, fees or assessments.

House Bill 6655 allowed the Comptroller and association group plans to pool health insurance rates for those small employers that they insure. It would also exempt small employer plans offered by the Comptroller or association groups from premium tax.

Florida

House Bill 1159 would allow any municipality which provides fire protection to any other incorporated municipality to assess and impose the excise tax on gross premium receipts from insurance policies covering property within the corporate limits of such other incorporated municipality.

House Bill 1813 provided that insurance companies may make a one-time binding election to calculate the salary credit on an affiliated group basis.

House Bill 105 exempted from the premium tax life insurance policies or annuity contracts issued by an insurer domiciled outside the US covering only persons who at the time of issuance are not residents of the US and are not nonresidents illegally residing in the US.

Florida is warning of additional assessments expected due to hurricane losses. Citizens Property Insurance Corporation is a corporation formed in 2002 by the Florida Legislature which provides insurance to homeowners in high-risk areas and others who cannot find coverage in the private insurance market. On August 26, 2005, the Board of Governors of Citizens levied an assessment on “assessable insurers” to cover Citizens’ $515 million deficit caused by 2004 hurricanes. Indications are that additional assessments for 2005 hurricane losses can be expected.

Georgia

House Bill 200 provided that the Subsequent Injury Trust Fund will reimburse a self-insured employer or an insurer for a subsequent injury occurring on or prior to June 30, 2006.

Hawaii

House Bill 160 amended the process for insurer assessments relating to the Compliance Resolution Fund to, among other things, give insurers a 60-day notice of assessments, and set a cap on total assessments on all lines of insurance in any one fiscal year.

Idaho

Senate 1030 clarifies that the Idaho Guaranty Association is not obligated to pay claims outside the express written terms of contracts issued by insolvent insurers and limits the interest the Association is obligated to pay.

House Bill 162 required the Guaranty Association to refund excess monies in the fund when the Association determines that they do not need the monies within the next two years.

Illinois

Senate Bill 2404 changed the method for paying filing fees. The Department will mail a quarterly invoice to the company for the filing fees required under Illinois section 408.

Indiana

House Bill 1033 amended the Brownfield credits provisions to repeal the credit against the premium tax.

Iowa

House Bill 360 provided that the Commissioner shall authorize the DOR to make a cash refund to an insurer in lieu of a credit against subsequent prepayment or tax liability if the insurer demonstrates the inability to recoup the funds paid via a credit.

Kentucky

Senate Bill 49 reorganized and renamed the Kentucky Revenue Cabinet to the Kentucky Department of Revenue. It also placed the premium tax oversight in the Division of Miscellaneous Taxes under the Office of Sales and Excise Taxes within the Department of Revenue.

House Bill 18 permitted the Department of Insurance to impose a penalty against an insurance company that willfully refuses to remit a fee or tax imposed by a city, county, charter county, consolidated local government or urban county government.

House Bill 278 specifically provided that no license fee or tax can be imposed on premiums received on high-deductible health plans.

Louisiana

House Bill 69 required motor vehicle insurers to provide to active military personnel based in Louisiana a discount on the premium on any automobile liability policy. The discount specifically would not be subject to premium tax.

Maine

House Bill 278 eliminated the biennial continuation fee on insurance producers.

House Bill 652 expanded the definition of annuity contracts subject to the Guaranty Fund Assessments.

The Maine Superior Court ruled that a title insurer's premium tax liability was based on premiums that were for insurance coverage only[175].

175. Stewart Title Guaranty Company v. Maine State Tax Assessor, Maine Superior Court, No. Ap-04-17, 5/5/05.

Maryland

Senate Bill 836 established a premium tax funded Health Care Provider Rate Stabilization Fund. The revenue is from premium tax paid by HMOs and managed care organizations.

House Bill 627 provided that a non profit HMO that is exempt under I.R.C. Section 501(c)(3) is also exempt from the premium tax on HMOs.

House Bill 11 provided a premium tax credit up to 50% of the amount contributed to a project in a priority funding area that is part of the Neighborhood and Community Assistance Program.

Schedule T Premium Reporting by Policyholder State of Residence

The NAIC cancelled its fall 2005 meeting and held several conference calls instead. The group deferred until the winter national meeting to discuss a proposal which would require reporting of premium for groups larger than 200 members to the actual state of residence of the member, not the state where the group policyholder is located on Schedule T.

Source: "NAIC Update: Financial And Actuarial Developments," Blue Cross Blue Shield Association, November 11, 2005.

Michigan

The Michigan Court of Claims held that the taxpayer could include certain credits in calculating the Michigan retaliatory tax[176].

176. Prudential Ins. Co. of America v. Dept. of Treasury, State of MI, No. 03-140-MT, Michigan Court of Claims, December 22, 2004

Minnesota

House Bill 138a provided the following premium tax rates for life insurers

1.875%	-	2006
1.75	-	2007
1.625	-	2008
1.5	-	after 12/31/08

The bill further provided for a definition of “direct business” that specifically includes stop-loss insurance purchased in connection with a self-insurance plan for employee health benefits but excludes reinsurance and pure self-insurance.

Senate Bill 69a specifically carved out warranty contract, service fee contracts and maintenance agreements from the premium tax.

Senate Bill 1998 included HMOs in the insurance fraud prevention account and required that the HMO be assessed.

House Bill 2228 clarified the premium tax base on HMOs to include all direct business received by the organization, network, or corporation or its agents in cash or otherwise.

Montana

House Bill 157 allowed companies to subtract the premium tax paid by the insurance company for the contract accumulated at rates of interest to calculate the minimum nonforfeiture amount.

Senate Bill 134 revised captive insurance company laws to provide that the tax is on all premiums written by the captive, not just Montana premium.

Senate Bill 275 required the insurer issuing an individual or group disability or health insurance policy to pay $1 per policy to the commissioner through June 30, 2007. Beginning July 1, 2007 the fee per policy would drop to $.70.

Senate Bill 133 provided for a premium tax credit for investment in the Equity Capital Investment Fund.

Nebraska

Legislative Bill 334 would increase the total available Community Development Assistance credit against the premium tax from $250,000 to $350,000.

New Jersey

Assembly Bill 4402 provided a special interim assessment for FY 2005 and an annual assessment thereafter on HMOs. HMOs are required to pay a 1% assessment on the net written premiums received by each HMO.
Assembly Bill 4401 provided that the 12 ½ % limitation/cap on New Jersey premium does not apply to health service corporations. It further provided that any life, accident or health insurance company in which a health service corporation owns stock, controls or otherwise becomes affiliated with, is subject to the premium tax.

The New Jersey Superior Court determined that the methodology used by the New Jersey Division of Taxation to calculate the retaliatory tax for out-of-state insurers eligible for the state's "premium cap" benefit is contrary to legislative intent and violates the Equal Protection Clause[177].

177. American Fire and Casualty Co. v. New Jersey Division of Taxation, No. A-2708-03T2, N. J. Superior Court, Appellate Division, March 9, 2005.

New Mexico

House Bill 444 clarifies that the premium tax surcharge on health insurance contracts is on hospital and medical expense incurred insurance or contracts; non-profit health care service plan contracts, excluding dental or vision-only contracts; and health maintenance organization subscriber contracts.

Senate Bill 975 imposes a $3 dollar surcharge on agent filing fees, HMO fees and foreign risk retention group fees. The surcharge is to fund bonds for finance and communication equipment.

New York

Senate Bill 3671 provided for a CAPCO Five starting in 2005 generating tax credits to be used starting in 2007. It also provided that credits authorized under Article 33 maybe transferred or sold to an affiliate subject to tax under Article 33 in New York. The transferability provision applies to all credits transferred on or after 8/1/2003.

Senate Bill 3669 and Assembly Bill 6843 increased the agent's license fee from $20 to $40 per year.

North Carolina

Senate Bill 622 provided that beginning with the 2007 taxable year, health maintenance organizations (HMOs) are subject to the general insurance gross premiums tax rate of 1.9%, rather than the current reduced rate of 1%. In addition, in lieu of the three estimated tax payments equivalent to one-third of the gross premiums tax due that are required to be paid by insurance companies with at least $10,000 in tax liability, HMOs with at least $10,000 in tax liability, not including the additional local fire and lightning tax, are required to make two equal installments of estimated premium tax liability for the 2007 taxable year. The annual charge levied on each insurance company was increased

from 5% to 5.5% of the company's premium tax liability for the 2005 tax year.

During the NAIC fall meeting, a proposal to provide accounting guidance for state tax credits was exposed for comment. The proposal provides guidance for state tax credits purchased by an insurer from another entity to offset the insurer's state income tax or premium taxes.

Source: "NAIC Update: Financial And Actuarial Developments," Blue Cross Blue Shield Association, November 11, 2005.

Ohio

House Bill 425 defined the premium tax base for bail bond insurers.

House Bill 66 in relevant part repealed the exemption from the unauthorized insurance and surplus lines taxes for industrial insurers as well as employer insureds. It also imposed a commercial activity tax on taxpayers, but insurance companies are exempt.

Oregon

Senate Bill 122 provided that the Oregon Medical Insurance Pool adjustments to the assessment of an insurer are discretionary based on the insurer's contribution to reducing enrollment in the Pool.

House Bill 2160 provided that the Surplus Line Association of Oregon may charge a surplus lines licensee a fee for reviewing surplus lines policies and for collecting the taxes.

Senate Bill 123 changed the date for the assessment of the Medical Insurance Pool from 12/31 to 3/31.

Pennsylvania

The Pennsylvania Commonwealth Court found that a New Jersey domiciled insurer should have included the New Jersey second injury fund assessment on the New Jersey side of the Pennsylvania retaliatory tax calculation because the fund assessment was equivalent to a license fee and was a burden against the insurer[178].

Puerto Rico

PC 1718 increases the premium tax rate from 4 to 6 percent. The tax rate on annuities is three percent. Note that even though the provision has passed it is not yet effective.

South Carolina

House Bill 3768 changed the procedures for applying and receiving the Jobs Tax Credit against the premium tax. The petition must now be made to and approved by the director of the Department of Insurance.

House Bill 4035 provided for a venture capital authority and allows a premium tax credit for investments in the authority.

Tennessee

House Bill 1253 provided that certain employee health benefit or welfare plans are not subject to the premium tax.

Senate Bill 2321 provided that groups pooling liabilities under workers' compensation provisions are required to pay the premium tax and surcharges.

178. Home Ins. Co. v. Commonwealth of Pennsylvania, Nos. 256, 257, and 259, Pennsylvania Commonwealth Court, May 13, 2005.

Texas

House Bill 3300 provided that an insurer may reinstate a personal automobile insurance policy canceled for non payment of premium if the premium owed is paid no later than the 60th day after date of cancellation by the insurer.

Senate Bill 14 provided that an insurance company may not claim a premium tax credit that the insurer is otherwise entitled to unless the insurer has complied with provisions that require the insurer to issue a refund on personal automobile insurance or residential property insurance policies where the policy premium is excessive or the policy is unfairly discriminatory.

Senate Bill 809 clarified that the Texas Health Insurance Risk Pool does not apply to accident insurance.

House Bill 2883 expanded the definition of member insurer for purposes of the Texas Life, Accident, Health, and Hospital Service Insurance Guaranty Association to include organizations which have a certificate of authority limited to the issuance of charitable gift annuities.

The Texas Court of Appeals upheld the Comptroller of Public Accounts' interpretation of the insurance premium and retaliatory taxes that allowed foreign title insurance companies to include only 15% of the premium tax in their retaliatory tax computation[179].

Utah

House Bill 195 clarified language requiring that domestic stock and mutual insurance companies pay tax as any other admitted insurance carriers.

179. First American Title Ins. Co. v. Strayhorn, No. 03-04-00342-CV, Texas Court of Appeals, June 3, 2005.

House Bill 191 eliminated premium tax on a policy that is written by a captive insurance company and replaced the tax with an annual fee.

House Bill 200 clarified the tax base for the Surplus Lines Tax. The tax base is the gross premium for a surplus lines transaction including the monetary consideration of the policy and all fees charges to the insured however designated.

Vermont

House Bill 130 provided that the worker's compensation insurance rate of contribution will remain at 0.4% for fiscal year 2006.

Virginia

Senate Bill 1059 modified the assessment for the Insurance Collateral Assessment Fund.

Washington

House Bill 1196 specifically included longshore and harbor workers' compensation act insurance in the definition of insurance covered by the Washington Insurance Guaranty Fund. The Fund will not cover any longshore and harbor workers' compensation act claims unless the insurer becomes insolvent after the effective date of the act.
House Bill 1299 repealed the premium tax credit for new employment for international service activities.

House Bill 1690 provided that premiums received by an HMO or a health care service contractor from the state of Washington as prepayments for health care services provided for the medical services program, the Washington basic health plan or Medicaid, are not subject to the 2% premium tax.

Guaranty Fund Net Assessments 1978 - 2003[1]

According to the National Conference of Insurance Guaranty Funds, in 2003 state guaranty funds assessed insurers $958.19 million to pay for insolvencies. After refunds of $56.54 million, insurers paid net assessments totaling $901.65 million.

Year	Net Assessment[2]	Year	Net Assessment[2]
1978	42,852,715	1991	434,845,812
1979	46,222,805	1992	360,522,206
1980	17,771,834	1993[3]	545,390,211
1981	49,772,896	1994[3]	524,901,618
1982	41,109,087	1995[3]	94,832,290
1983	30,619,239	1996	124,169,554
1984	97,435,034	1997	263,693,050
1985	292,417,521	1998	263,627,912
1986	509,409,508	1999	201,340,339
1987	903,228,359	2000	328,609,659
1988	464,840,383	2001	734,672,749
1989	713,869,682	2002[4]	1,208,952,740
1990	433,562,308	2003[4]	901,648,410
		Total	9,641,964,955[5]

1) Excludes New York and Workers Compensation Security Funds in New Jersey and Pennsylvania.
2) Assessment less refunds.
3) Includes separate assessments for insolvencies due to Hurricane Andrew totaling $248,542,070
4) Excludes data for the Louisiana Insurance Guaranty Association.
5) Includes pre-1978 net assessments

Source: The Insurance Information Institute Fact Book 2006, Insurance Information Institute, 2006, page 31.

West Virginia

Senate Bill 666 clarified that insurance companies that pay the state premium tax and surcharge are exempt from the net income and franchise taxes. The bill originally excluded from the income tax only that income which is generated from premiums, thus subjecting "other income" of the insurance company to the income tax.

Senate Bill 418 provided an increase in the Examination Assessment up to $5,000 for property and casualty insurers. The bill further provided that the policy surcharge against any fire insurance or casualty insurance policy for the fire department fund is .55% after December 31, 2005, instead of the current 1%.

Senate Bill 427 set the application for a certificate of authority or amendment to the application fee for HMOs at $200 and set the renewal of the certificate of authority at the same amount as other insurers.

Senate Bill 1004 provided for a new Workers' Compensation Commission.

Wisconsin

Assembly Bill 100 creates a Health Insurance Risk Sharing Plan Assessment Credit against the premium tax. The Governor originally vetoed the bill but the veto was overridden.

chapter 12

Tax Accounting

Introduction

The interplay between financial reporting and tax reporting has resulted in financial reporting developments with significant implications for insurance tax departments. The Statutory Accounting Principles Working Group adopted changes to SSAP 10 affecting the preparation of quarterly statutory financial statements. The Financial Accounting Standards Board issued an Exposure Draft of a proposed interpretation, *Accounting for Uncertain Tax Positions—an Interpretation of FASB Statement 109*. The Exposure Draft contains proposed guidance on the recognition and measurement of uncertain tax positions and addresses the accrual of interest and penalties related to tax uncertainties. These developments will require tax practitioners to work closely with financial reporting staff to insure that amounts are properly reported.

Changes to SSAP 10

The Statutory Accounting Principles Working Group (SAPWG) adopted the following changes to SSAP 10, Section 12.24 with respect to insurers' tax footnote disclosures:

SSAP 10 - EXHIBIT A: Implementation Questions and Answers Section 12.24:

> "All of the disclosures would be completed in the year-end Annual Statement and audited statutory financial statements. The disclosures of paragraphs 18, 20b, 21 (on a prospective basis) and 23 *should* (formerly "Must") *be presented* (formerly "in the First Quarterly statement") *in accordance with paragraph 57 of the Preamble, therefore these notes would only be presented in the first, second and third Quarterly Statements if the underlying data changed significantly.*"

Prior to the change, SSAP 10 required insurers to provide a full tax footnote disclosure in the first quarterly statutory financial statement of each year. The disclosure requirement generally resulted in a different level of disclosure for year-end and first quarter reports from the disclosures required to be included in the second and third quarter reports. Consequently, the first quarter disclosure is generally not consistent with the second and third quarter reports.

The change is intended to improve the consistency of income tax disclosure among quarters and ease the burden on insurers while providing the regulators more useful information. Insurers should assess the impact of this change on their quarterly statutory financial statement filings. This revision should help reduce insurers' quarterly tax-related disclosures where no significant changes from the prior year-end (or prior quarter) have occurred.

Where is Insurance Accounting Headed in the U.S.?

At a recent seminar on International Financial Reporting Standard (IFRS), a survey of attendees showed that:

- 75 percent believe IASB and FASB will unify standards within 10 years
- 66 percent think the IASB will ultimately adopt a fair-value model for Phase II insurance.
- 38 percent prefer fair value over current U.S. GAAP, and only 13 percent are leaning toward an embedded-value approach.

Source: Mark Freedman, "Where is Insurance Accounting Headed in the U.S.?" The Insurance Tax Review, October 2005, Page 669.

FASB Exposure Draft on Uncertain Tax Positions

The Financial Accounting Standards Board (FASB) issued an exposure draft (ED) of a proposed interpretation, *Accounting for Uncertain Tax Positions—an Interpretation of FASB Statement 109*. The ED contains proposed guidance on the recognition and measurement of uncertain tax positions and addresses the accrual of interest and penalties related to tax uncertainties.

Contrary to most current approaches to accounting for tax uncertainties, which use contingent liabilities, the conceptual underpinnings of the proposed guidance are based on an asset recognition model using a two-step approach: a determination of whether to initially recognize the financial statement effects of a tax position (based on a qualitative evaluation of the merits of the tax position) followed by measurement of the amount of benefit to recognize (based on a quantitative assessment of the outcome of the uncertainty).

Recognition: Under the FASB's initial proposal, the recognition of uncertain tax benefits is based on whether the underlying tax position is "probable" of being sustained under audit. The FASB proposes that a company must presume that the relevant taxing authority will examine the tax position.

Late in the year, after receiving several comment letters referring to the "probable" standard, the FASB met and tentatively decided that the threshold for initially recognizing any benefit from an uncertain tax position should be when the position is "more likely than not" of being sustained, rather than "probable" of being sustained (as had been proposed in the exposure draft issued in July). This lower recognition threshold is directionally consistent with many of the comment letters received by the FASB and, if approved as part of a final standard, will generally result in the recognition in financial statements of the benefit of more uncertain tax positions.

Measurement: Once a company concludes that a filing position is p*robable (or more likely than not,* if the FASB approves this language) of being sustained, it should measure the amount of benefit based on the "best estimate" of the amount that will ultimately be sustained upon (1) settlement or (2) resolution through the litigation and appeals process.

Subsequent Periods: Each reporting period companies must reassess their uncertain tax positions. If a position that was previously determined not to be *probable (*or *more likely than* not*,* if the FASB approves this language) becomes probable (or *more likely than not*) in a subsequent period, the company would recognize a benefit in that period, based on the taxpayer's best estimate. If a company concludes that it is more likely than not that the tax position will not be sustained, the company would derecognize the benefit and record a corresponding charge to income tax expense currently.

Interest and Penalties: Inherent in the Board's proposal is the notion that a benefit claimed on a tax return that is not probable of being sustained on its technical merits effectively constitutes a borrowing from the government (resulting in an interest charge), at a minimum, and/or a misapplication of tax law (resulting in a penalty). Therefore, interest should be calculated on the entire balance of the liability for unrecognized uncertain tax benefits. Penalties should be accrued in accordance with the respective tax laws.

Disclosures: The ED prescribes no "new" disclosure requirements for uncertain tax positions. Rather, the proposed guidance refers to existing disclosures required by FAS 5. Companies should provide disclosures that are sufficient to ensure that the reader of the financial statements can gain an understanding of the nature of the positions taken, the risk of a future cash outflow, and any other qualitative considerations relevant to management's expectations about the eventual outcome.

The ED had a proposed effective date of December 15, 2005, but in its November meeting, the FASB decided to defer until the first quarter of 2006 any decision on the exposure draft.

At a January 2006 FASB meeting, the FASB continued its deliberations on the accounting for uncertain tax positions.

The FASB discussed the following items:

1. Subsequent changes in recognition or measurement require support by some type of identifiable new event, information, or experience, rather than merely a reassessment of previously existing information.
2. For interim reporting purposes, subsequent changes will be treated as discrete items to the extent they relate to uncertainties of prior annual periods; however, they will be treated as effective rate revisions, in general, to the extent they relate to current annual period uncertainties.
3. The income statement classification of interest and penalties will be treated as an accounting policy election, with required disclosure of elected policy and recorded amounts.
4. The final interpretation will be effective for annual periods beginning after December 15, 2006, with early adoption encouraged. Thus, the adoption would occur in the first quarter of 2007 for calendar year public companies.
5. The cumulative catch-up adjustment will be to retained earnings at the beginning of the year of adoption.

chapter 13

Appendices

Appendix A

Cases/Petitions

Addis v. Commissioner of Internal Revenue, 125 S. Ct. 1334 (2005)

The U.S. Supreme Court denied certiorari for *Addis v. Commissioner*, an appeals court decision which denied the taxpayer a charitable contribution deduction for payments made in connection with a charitable split-dollar insurance arrangement.

American Family Mutual Insurance Co. v. U.S., 376 F. Supp. 2d 909 (2005)

The U.S. District Court ruled against American Family Mutual Insurance Company finding that American Family cannot claim any additional adjustment under Section 481 because Section 832(b)(4)(C) provides explicit instructions for the transition adjustment for unearned premiums.

Blue Cross & Blue Shield of Wisconsin v. U.S., 94 A.F.T.R. 2d (unpublished) (Fed. Cir., 2004)

Blue Cross and Blue Shield Wisconsin (BCW) was remanded to the Claims' Court. The Claims' Court previously found that an IRS Closing Agreement did not allow BCW to use its actual 1987 data, rather than the estimate it computed at the beginning of 1987, to calculate its "unpaid loss reserve." The Circuit Court found the extrinsic evidence not persuasive, and therefore, the Circuit Court reversed the case and remanded it to the Federal Court of Claims for reconsideration.

Capital Blue Cross and Subsidiaries v. Commissioner of Internal Revenue, 431 F.3d 117 (Third Cir., 2005)

The Appeals Court reversed and remanded the case to the Tax Court for a determination of Capital's basis in terminated subscriber contracts.

Garza v. Commissioner of Internal Revenue, T.C. Summ. Op. 2005-96 (2005)

The Tax Court ruled that a retired insurance agent's renewal commissions were income subject to self-employment tax.

Gilbert v. Commissioner of Internal Revenue, T.C. Summ. Op. 2005-176 (2005)

The Tax Court ruled that a retired insurance agent's renewal commissions were income subject to self-employment tax.

Jones v. U.S., 355 F. Supp. 2d 1292 (S.D. Ala., 2004)

The U.S. District Court ruled that termination payments received by David E. Jones, a former State Farm Insurance agent, should be taxed as ordinary income, and not as capital gains.

Massachusetts Mutual Life Insurance Company v. United States, 66 Fed. Cl. 217 (Fed. Cl,. 2005)

The U.S. Federal Court of Claims denied summary judgment in Massachusetts Mutual Life Insurance Co. v. U.S. regarding when the right to receive supplemental premium income is "fixed."

OBH, Inc. v. United States, 397 F.Supp.2d 1148 (D. Neb., 2005).

The U.S. District Court ruled in favor of the Taxpayer in a dividends-received deduction controversy implicating the debt financing rules of Section 246A.

Tillman ex. Re. Estate of Tillman v. Camelot Music, Inc., 408 F 3d 1300 (C.A. 10 Okla., 2005)

The 10th Circuit Court of Appeals ruled in Tillman v. Camelot Music Inc. that an employer does not have an insurable interest in the life of an employee with no special importance to the company for purposes of purchasing a corporate-owned life insurance policy.

Trantina v. U.S., WL 1624889 (D. Ariz., 2005)

The U.S. District Court ruled that an agent's termination payments are ordinary income and not long-term capital gains.

Weiner v. Commissioner of Internal Revenue, 125 S.Ct. 1332 (2005)

The U.S. Supreme Court denied certiorari for *Weiner v. Commissioner*, an appeals court decision which denied the taxpayer a charitable contribution deduction for payments made in connection with a charitable split-dollar insurance arrangement.

Xcel Energy Inc. v. United States (96 A.F.T.R. 2d 2005-6508 (D. Minn); 2005 WL 2577112)

The District Court ruled that although questions of fact relating to the economic substance of a corporate-owned life insurance program precluded summary judgment, the taxpayer had an insurable interest in its employees.

IRS Rulings/Procedures/Notices/FSAs

Rev. Rul. 2005-6, 2005-6 I.R.B. 471

The IRS held that for purposes of determining whether a contract qualifies as a life insurance contract or as a modified endowment contract, charges for qualified additional benefits should be

taken into account under the expense charge rule of Section 7702(c)(3)(B)(ii).

Rev. Rul. 2005-7, 2005-6 I.R.B. 464

The IRS provided guidance as to how, for purposes of determining whether a segregated asset account is adequately diversified under Section 817(h), the look-through rule of Treas. Reg. Section 817(h)(4) applies to an investment in a regulated investment company that, in turn, owns an interest in another RIC.

Rev. Rul. 2005-29, 2005-21 I.R.B. 1080

The IRS released prevailing state assumed interest rates for the determination of reserves under Section 807 for contracts issued in 2004 and 2005, supplementing Rev. Rul. 92-19.

Rev. Rul. 2005-30, 2005-20 I.R.B. 1015

The IRS ruled that if the owner-annuitant of a deferred annuity contract dies before the annuity starting date, and the beneficiary receives a death benefit under the annuity contract, the amount received by the beneficiary in a lump sum or in a series of periodic payments in excess of the owner-annuitant's investment in the contract is includible in the beneficiary's gross income as income in respect of a decedent.

Rev. Rul. 2005-31, 2005-21 I.R.B. 1084

The IRS addressed the limitations applicable to dividends received from a regulated investment company.

Rev. Rul. 2005-33, 2005-23 I.R.B. 1155

Additions to a premium stabilization reserve are return premiums for purposes of determining the amount of premiums earned on insurance contracts during the taxable year under Section 832(b)(4).

Rev. Rul. 2005-40, 2005-27 I.R.B. 4

The IRS issued guidance on the qualification of certain arrangements as "insurance" for federal income tax purposes, specifically addressing the risk distribution requirement of a purported insurance contract under four fact scenarios.

Rev. Rul. 2005-58, 2005-36 I.R.B. 465

The IRS published the final determination under Section 809 of the "differential earnings rate" for 2004.

Rev. Proc. 2005-25, 2005-17 I.R.B. 962

The IRS provided guidance on how to determine the fair market value of a life insurance contract. The guidance modifies and supersedes Rev. Proc. 2004-16, released in February 2004 and is applicable to distributions from qualified plans, permanent benefits under Section 79, transfers under Section 83, and contributions to and distributions from nonexempt employees' trusts.

Rev. Proc. 2005-64, 2005-46, I.R.B. 492

The IRS provided the domestic asset/liability percentages and domestic investment yields needed by foreign life insurance companies and foreign property and liability insurance companies to compute their minimum effectively connected net investment income under Section 842(b) for taxable years beginning after December 31, 2003.

Rev. Proc. 2005-72, 2005-49, I.R.B. 1078

The IRS prescribed the loss payment patterns/discount factors for the 2005 accident year.

Rev. Proc. 2005-73, 2005-49 I.R.B. 1090

The IRS prescribed the salvage discount factorsfor the 2005 accident year.

Notice 2005-11, 2005-7 I.R.B. 493

A taxpayer may incur a penalty under Section 6707A with respect to each failure to provide a disclosure statement that is required to be attached to an original or amended return filed after October 22, 2004 regardless of whether the original return was due on or before October 22, 2004.

Notice 2005-12, 2005-7 I.R.B. 494

The IRS provided interim guidance relating to Section 6662A, as added by the Jobs Act, and Sections 6662 and 6664, as amended by the Jobs Act. Notice 2005-12 sets forth rules and standards for adequate disclosure for purposes of Sections 6662A and 6664(d), a special rule for amended returns under Section 6662(e), and various rules relating to "disqualified tax advisors" under Section 6664(d).

Notice 2005-18, 2005-9 I.R.B. 634

The IRS published a tentative determination under Section 809 of the "differential earnings rate" for 2004. The rate is used by mutual life insurance companies to calculate their federal income tax liability for taxable years beginning in 2004.

Notice 2005-20, 2005-9 I.R.B. 635

The IRS addressed questions of statutory interpretation under Section 172(f)(1)(B) prior to its amendment by Section 3004(a) of the Tax and Trade Relief Extension Act of 1998 (former Section 172(f)(1)(B)).

Notice 2005-35, 2005-21 I.R.B. 1087

The IRS provided procedures under which a list identifying the contracts subject to a closing agreement under Rev. Rul. 2005-6 may be submitted to the IRS in electronic format.

Notice 2005-38, 2005-22 I.R.B. 1100

The IRS issued Notice 2005-38, providing guidance for U.S. companies that elect to repatriate dividends from foreign subsidiaries subject to the temporary dividends-received deduction available under the American Jobs Creation Act.

Notice 2005-45, 2005-24 I.R.B. 1228

The IRS provided interim guidance to taxpayers on the limitation under Section 274(e) on the deductible amount of trade or business expenses for use of a business aircraft for entertainment.

Notice 2005-49, 2005-27 I.R.B. 14

The IRS requested comments on issues that should be addressed in future guidance concerning the standards for determining whether an arrangement constitutes insurance for federal income tax purposes.

Announcement 2005-80 (November 14, 2005)

The IRS provided a settlement initiative under which taxpayers may resolve the tax treatment of twenty-one "potentially abusive" tax transactions with the IRS.

Private Letter Rulings and Technical Advice

PLR 200508002 (February 25, 2005)

The look-through rule of Treas. Reg. Section 1.817-5(f) applies to a subaccount that invests in an Upper-Tier Fund such that a pro rata share of the assets of any Lower-Tier Fund in which the Upper-Tier Fund invests will be treated as assets of the subaccount for purposes of applying the diversification test.

PLR 200509005 (March 4, 2005)

Vehicle service agreements issued by Company will be insurance contracts for federal tax purposes and Company will be an insurance company within the meaning of Section 831 if more than half of Company's business consists of issuing the agreements.

PLR 200512005 (March 25, 2005)

An extension of time was granted for a request for change in accounting method under Sections 832(b)(4) and 832(b)(5).

PLR 200514001 (April 8, 2005)

The transfer of two whole life insurance policies from one trust to another will be disregarded for Federal income tax purposes, and the "transfer-for-value" rule of Section 101(a)(2) will not diminish the exclusion from gross income for amounts received by the beneficiaries of the policies.

PLR 200514002 (April 8, 2005)

The transfer of two whole life insurance policies from one trust to another will be disregarded for Federal income tax purposes, and the "transfer-for-value" rule of Section 101(a)(2) will not diminish the exclusion from gross income for amounts received by the beneficiaries of the policies.

PLR 200518005 (May 6, 2005)

Taxpayer will not possess any incidents of ownership over the life insurance policies held as assets of Trust A and Trust B because Taxpayer renounced her rights as co-trustee of those trusts. Additionally, the proceeds of the life insurance policies held as assets of Trust A and Trust B will not be included in Taxpayer's gross estate.

PLR 200518010 (May 6, 2005)

A reinsurance arrangement between a parent company, its subsidiaries, unrelated entities, and its foreign captive insurance company is not insurance for federal income tax purposes; and, as such, the arrangement is not subject to the federal excise tax under Section 4371.

PLR 200518061 (May 6, 2005)

The proposed transfer of a life insurance policy, even though for valuable consideration, will be disregarded for federal income tax purposes, and will not affect the exemption from gross income for life insurance proceeds.

PLR 200519025 (May 13, 2005)

The IRS waived the failure of certain life insurance contracts to meet the guideline premium requirements of Sections 101 and 7702.

PLR 200520035 (May 20, 2005)

A foreign company which made an election under Section 953(d) did not qualify as an insurance company for federal income tax purposes, and does not continue to qualify for exemption from federal income tax as an organization described in Section 501(c)(15).

PLR 200525004 (June 24, 2005)

Vehicle service contracts are insurance for Federal tax purposes.

PLR 200525007 (June 24, 2005)

The IRS waived failure of certain contracts to satisfy the requirements of Section 7702.

PLR 200528018 (July 15, 2005)

A remittance payable by a life insurance company to policy owners on the early surrender of their contracts is part of the contracts' cash surrender value and the company's error in not treating the remittance as part of the cash surrender value can be waived.

PLR 200528023 (July 15, 2005)

Death benefits paid to Corporation, which were later paid out to Decedents under a class action law suit, were not deductible death benefits to the decedents, but taxable amounts paid to settle litigation.

PLR 200528027 (July 15, 2005)

An insolvent insurance company continues to qualify as exempt from federal income tax under Section 501(a) as an organization described in Section 501(c)(15).

PLR 200529008 (July 22, 2005)

A company that does not qualify as an insurance company for federal income tax purposes is not exempt under Section 501(c)(15).

PLR 200531001 (August 5, 2005)

The IRS granted a reciprocal underwriter's request to revoke an election under Section 835.

PLR 200531019 (August 5, 2005)

The IRS revoked an organization's tax-exempt status under Section 501(c)(15) because it failed to qualify as an insurance company as defined under that provision.

PLR 200531022 (August 5, 2005)

The IRS revoked an organization's tax-exempt status under Section 501(c)(15) because it failed to qualify as an insurance company as defined under that provision.

PLR 200531023 (August 5, 2005)

The IRS revoked an organization's tax-exempt status under Section 501(c)(15) because it failed to qualify as an insurance company as defined under that provision.

PLR 200531028 (August 5, 2005)

The IRS revoked an organization's tax-exempt status under Section 501(c)(15) because it failed to qualify as an insurance company as defined under that provision.

PLR 200537036 (September 16, 2005)

A taxpayer's provision of otherwise unallowable health benefits to adult former dependents of members will not cause the organization to lose its exempt status.

PLR 200538004 (September 23, 2005)

The IRS confirmed that a captive insurance company's income was excludable from gross income for federal income tax purposes under Section 115.

PLR 200538012 (September 23, 2005)

An organization providing workers' compensation insurance is an insurance company for Federal income tax purposes.

PLR 200538039 (September 23, 2005)

An organization providing workers' compensation insurance does not qualify for exemption under Section 501(c)(27) or Section 501(c)(6).

PLR 200540009 (October 7, 2005)

The IRS granted a 60-day extension to a foreign insurance company that inadvertently failed to file a timely Section 953(d) election to be treated as a domestic corporation for U.S. tax purposes.

PLR 200544006 (November 4, 2005)

The IRS was requested to rule on the federal income tax consequences of a proposed transaction in which a mutual life insurance company is to convert to a stock life insurance company. The IRS held that the transaction qualified as a tax-free reorganization.

PLR 200545051 (November 10, 2005)

The IRS revoked an organization's tax-exempt status under Section 501(c)(15) because it failed to qualify as an insurance company as defined under that provision.

PLR 200545052 (November 10, 2005)

The IRS revoked an organization's tax-exempt status under Section 501(c)(15) because it failed to qualify as an insurance company as defined under that provision.

PLR 200550044 (December 16, 2005)

The IRS revoked an organization's tax-exempt status under Section 501(c)(15) because it failed to qualify as an insurance company as defined under that provision.

PLR 200550045 (December 16, 2005)

The IRS revoked an organization's tax-exempt status under Section 501(c)(15) because it failed to qualify as an insurance company as defined under that provision.

PLR 200551028 (December 23, 2005)

The proposed receipt and retention of demutualization proceeds by a dissolved corporation does not constitute a receipt of plan assets or plan property by an employer so as to effectuate an employer reversion from a qualified plan within the meaning of section 4980.

PLR 200551029 (December 23, 2005)

The proposed receipt and retention of demutualization proceeds by a dissolved corporation does not constitute a receipt of plan assets or plan property by an employer so as to effectuate an employer reversion from a qualified plan within the meaning of section 4980.

PLR 200552021 (December 30, 2005)

An insolvent insurance company continues to qualify as exempt from federal income tax under Section 501(a) as an organization described in Section 501(c)(15).

TAM 200511015 (March 18, 2005)

A taxpayer may deduct contributions to a Voluntary Employees Benefit Association Trust that are used to purchase life insurance policies, the proceeds from which are used by the VEBA to fund certain post-retirement benefits provided by the taxpayer to its employees.

TAM 200517030 (April 29, 2005)

The initial nonrefundable assessment paid to a state insurance fund is deductible as an ordinary and necessary business expense.

TAM 200528026 (July 15, 2005)

A taxpayer's issuance of stock after its conversion to a for-profit stock entity constituted a material change in structure under Section 833(c)(2).

ILM 200504001 (January 28, 2005)

Damages from a class action lawsuit against an insurer are not includible in the taxpayer's income to the extent of the taxpayer's basis in the insurance policy.

ILM 200504030 (January 28, 2005)

A taxpayer's change in treatment of reserves for deferred and uncollected premiums was an unauthorized change in accounting method.

Regulations

T.D. 9029, 2005-31 I.R.B. 153

The IRS issued final regulations relating to the election to expense the cost of property subject to Section 179. The regulations reflect changes to the law made by the Jobs and Growth Tax Relief Reconciliation Act of 2003 and the American Jobs Creation Act of 2004.

T.D. 9223, 2005-39 I.R.B. 591

The IRS released final regulations under Section 402(a) regarding the amount includible in a distributee's income when life insurance contracts are distributed by a qualified retirement plan and regarding the treatment of property sold by a qualified retirement plan to a plan participant or beneficiary for less than fair market value. The IRS also released final regulations under Sections 79 and 83 regarding the amounts includible in income when an employee is provided permanent benefits in combination with group-term life insurance or when a life insurance contract is transferred in connection with the performance of services.

T.D. 9185, 2005-12 I.R.B. 749

The IRS issued final regulations under Section 817(h) that are designed to limit the use of life insurance and annuity contracts as a way to avoid current taxation of investment earnings.

T.D. 9226, 2005-43 I.R.B 772

The IRS issued final regulations under Section 864 relating to the determination of income of foreign insurance companies that is effectively connected with the conduct of a trade or business within the U.S. The regulations provide that the exception to the asset-use test for stock shall not apply in determining whether the income, gain, or loss from portfolio stock held by foreign insurance companies constitutes effectively connected income.

T.D. 9226, 2005-45 I.R.B 930

The IRS issued proposed regulations under Section 4371 under which qualified single-owner eligible entities that currently are disregarded as entities separate from their owners for Federal tax purposes would be treated as separate entities for employment tax and certain excise taxes.

T.D. 9175, 2005-10 I.R.B. 665

The IRS issued temporary and proposed regulations under Section 6033 requiring certain large corporations and tax-exempt organizations to electronically file their income tax or annual information returns. The electronic filing requirements only apply to entities that file at least 250 returns, including income tax, excise tax, information, and employment tax returns, during a calendar year.

T.D. 9230, 2005-52 I.R.B 1198

The IRS issued final regulations under Sections 6043 and 6045 requiring information reporting by a corporation if control of the corporation is acquired, or the corporation has a substantial change in capital structure, and the corporation or any shareholder is required to recognize gain under Section 367(a).

T.D. 9229, 2005-48 I.R.B. 1051

The IRS issued temporary and proposed regulations under Section 6081 that permit most individual and business taxpayers to request an automatic, six-month extension of time to file certain tax returns.

70 FR 73393-01, REG-107722-00

Proposed regulations under Section 6655 provide guidance for corporations to compute their estimated tax liabilities.

70 FR 29671-01, 2005-25 I.R.B. 1293

The IRS issued proposed regulations under Section 7702 explaining how to determine the attained age of an insured for purposes of testing whether a contract qualifies as a life insurance contract for Federal income tax purposes.

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