2003 Insurance Tax Year in Review: Part I -- Federal Tax Matters

by Richard J. Burness, Gregory L. Stephenson, and J. Howard Stecker

In the first installment of a four-part report, representatives from Deloitte & Touche's Tax Practice group outline and analyze significant, federal tax developments affecting the insurance industry during 2003.

Date: Feb. 26, 2004

Special Reports

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Overview

[1] In our 2003 Halftime Report,[1] we concluded by pondering whether the last six months of 2003 would place new tax burdens on the insurance industry in addition to nontax burdens stemming from a weak economy and the continuing war on terrorism. Well, six months later, it appears that natural catastrophes such as Hurricane Isabel, accompanied by man-made disasters such as the Northeast Blackout, caused more damage to the insurance industry than did any new tax developments. However, unlike hurricanes and blackouts, where the damage can be assessed and the necessary repairs begun in a timely manner, insurance tax developments need time to come of age. Many of the developments of 2003 -- which span all segments of the industry and drive to the core of how an insurance company generates earnings -- will evolve into full-fledged controversies in the years to come.

[2] Moreover, during 2003 the whole tax shelter debate continued to pull in various forms of insurance products and appeared primed to place new burdens on insurance company tax departments to meet the rigorous reporting requirements. If that were not enough, Congress and the Securities and Exchange Commission (SEC) have implemented rules under Sarbanes-Oxley legislation that subjects tax department operations to a whole new level of scrutiny by internal and external auditors.

[3] This article will explore these and other developments -- including some bright spots -- in the insurance tax world during 2003. Section I provides a brief overview of some of the key guidance and developments that occurred during 2003 that cut across all segments of the industry. Section II -- The Pronouncements -- focuses on developments in specific industry segments. Life insurance developments described in this section include rulings dealing with such matters as the calculation of tax reserves and the calculation of the separate account dividends received deduction. Blue Cross and Blue Shield developments include several higher courts either reversing or affirming lower court decisions against taxpayers. The noninsurance developments include IRS notices that, while not insurance-specific, are

nonetheless of significance to insurance companies.

Format

[4] The *2003 Insurance Tax Year in Review* article consists of four separate pieces: Federal Tax Matters (Part I), Product Tax Matters (Part II), State and Local Tax Matters (Part III), and International Tax Matters (Part IV). Each part is broken down into topical sections that highlight developments of lasting significance to insurance companies. Similar to the format utilized in previous years, we have provided only brief discussions of the selected developments and cited the appropriate issue of *The Insurance Tax Review* for a more complete discussion and full text. For your convenience, Tax Analyst's citations and headnotes are included in the areas designated "Citation" and "Overview," respectively. In addition, Tax Analysts's headlines are utilized to introduce each development discussed. An appendix prepared by Tax Analysts includes a full listing of insurance tax pronouncements reported in *The Insurance Tax Review* in 2003.

Section I -- Guidance Priorities, Regulations, and Legislative Developments

[5] Before getting into the insurance-specific court cases, public and private rulings, and other developments that occurred this past year, we first take a look at a few general pronouncements that help define where the Service has focused, and continues to focus, its energies and where Congress has spent time -- without tangible results to show for its efforts -- on tax legislation in 2003.

IRS, Treasury Release 2003-2004 Priority Guidance Plan

[6] **Citations:** 2003-2004 Priority Guidance Plan (July 24, 2003). For the full text, see *Doc 2003-17368 (25 original pages)* [**PDF**] or *2003 TNT 143-7*. 2002-2003 Priority Guidance Plan, including Three Quarterly Updates. For the full text, see *Doc 2003-19973 (48 original pages)* [**PDF**] or *2003 TNT 174-6*.

[7] **Overview:** The IRS and Treasury released their 2003- 2004 business plan, which lists tax regulations and other administrative guidance that they expect to publish by fiscal year- end. The Treasury Department and the IRS have issued an annotated list of the nearly 350 guidance items published for 2002-2003.

[8] **Discussion:** This year's guidance plan continues last year's focus on issuing timely guidance. The plan targets the following insurance-specific priorities for the period from July 2003 through June 2004:

1. Revenue ruling concerning reserves used to calculate required interest under section 812;

2. Guidance regarding substantially equal periodic payments under section 72(q);

3. Guidance regarding 2001 CSO mortality tables;

4. Treatment of split-dollar life insurance;

5. Guidance on the procedures for claiming treaty waiver of insurance excise tax; and

6. Guidance on cross-border insurance issues.

[9] With the number of items proposed by the Service and Treasury, and their commitment to providing quarterly updates on their progress, it is no surprise that it takes time for proposed items to be finalized. For example, the much anticipated (although disappointing) guidance on split-dollar life insurance was released on September 17, 2003, almost 15 months after the proposed regulations were released in July of 2002. However, as the update of the 2003 guidance plan shows, Treasury and the IRS are staying on script with regards to issuing the guidance planned. There were five insurance-specific plan items for 2003, and guidance was issued for each item. Moreover, the update identifies five additional projects for which guidance was issued during this period that were not on the original plan. So their focus on producing guidance in a more timely manner seems to be working. Yet, one is left to wonder if the focus on volume and speed might adversely affect the government's ability to provide meaningful guidance that is based upon a thorough analysis and study of an issue.

IRS Publishes Proposed Transfer Pricing Regulations on Services and Intangibles

[10] **Citations:** REG-146893-02 (Sept. 5, 2003). For the full text, see *Doc 2003-19952 (139 original pages)* [**PDF**] or *2003 TNT 178-9*. REG-115037-00; 68 F.R. 53448-53482 (Sept. 10, 2003). For the full text, see *Doc 2003-20158 (35 original pages)* [**PDF**] or *2003 TNT 178-21*.

[11] **Overview:** The IRS published proposed regulations on the treatment of controlled services transactions under section 482 and the allocation of income from intangibles, particularly with respect to contributions by a controlled party to the value of an intangible that is owned by another controlled party. The proposed regulations provide updated guidance that is necessary to reflect economic and legal developments since the issuance of the current guidance.

[12] **Discussion:** There is a growing trend for global insurance organizations to centralize administrative functions and charge other group members for these services. U.S. insurance regulatory rules have generally required cost sharing arrangements be priced at cost without mark-up. Taxpayers have generally relied upon this state law requirement to substantiate their intercompany cost sharing arrangements. However, the proposed regulations effectively eliminate the cost-only safe harbor for low-margin services, such as back-office support, contained in the current section 482 regulations, replacing it with a "simplified" cost-plus method. The new method is absurdly complex and restricted to a much smaller class of services. For example, for a service to qualify for cost-only treatment under the new method, rigorous analysis and the avoidance of numerous limitations and restrictions will be required. Further, there is no "safe-harbor" definition.

[13] Instead of clarifying the current regulations, the proposed regulations change the rules for ownership of intangible property for purposes of section 482 and will likely create more confusion and uncertainty, not clarity. There is a blurring of the distinction between the provision of services and the ownership and/or transfer of an intangible income (and thus higher profits) to certain types of activities traditionally thought to be service activities.

Taxpayers in general have waited almost 10 years since the original regulations were issued for this critical guidance; unfortunately, the wait does not appear to have been worthwhile. Many aspects of these proposals will most likely be highly controversial, increasing transfer pricing burdens, costs, and the uncertainty of the IRS audit process. These proposed regulations could also have a significant impact on how operations are structured. It will be interesting to see the reaction of foreign taxing authorities to these new rules and what changes, if any, are brought about to counter their effects. While these proposed regulations speak to simplification, it appears they only add to the overall complexity of compliance within a global insurance organization.

Frequently Asked Questions Under Sarbanes-Oxley

[14] **Citations:** Office of the Chief Accountant: Application of the January 2003 Rules on Auditor Independence Frequently Asked Questions. For the full text, see *Doc 2003-18631 (12 original pages)* [**PDF**] or *2003 TNT 158-6* .

[15] **Overview:** The Securities and Exchange Commission, Office of the Chief Accountant released the answers to frequently asked questions regarding the January 2003 rules on auditor independence.

[16] **Discussion:** With the effective date for implementation less than a year away for large U.S. issuers, the Sarbanes-Oxley Act (the Act) has launched a flurry of activity among taxpayers and tax advisors alike. Each sector is trying to decipher its role (and the limitations thereon) in the corporate governance and financial reporting process. As our Halftime Report discussed, the Act greatly affects the tax function even though it makes no specific mention of tax departments. (For the full text of the Sarbanes-Oxley Act of 2002, see *Doc 2002-17383 (130 original pages)* [**PDF**] or *2002 TNT 144-25* *.)*

[17] In January, 2003, the SEC adopted rules on Strengthening the Commission's Requirements Regarding Auditor Independence (Release No. 33-8183, hereinafter "Release") which provided more detailed explanations of how the provisions of the Act were to be implemented by public companies. However, while the Release provided a significant amount of details on implementation, a variety of questions remained. In order to provide guidance on a number of these questions, the Office of Chief Accountant released the Frequently Asked Questions (FAQ). Although the Release and FAQ deal in large part with audits of public company financial statements, they also address several tax-specific requirements -- notably, whether a tax partner is included within the definition of an audit partner, whether income tax preparation software developed by a company's audit firm can be utilized without impairing the audit firm's independence, and the level of specificity required in obtaining preapproval of non-audit services by the company's auditors. While none of these items in and of themselves are earth-shattering, they do represent additional compliance burdens on corporate tax departments.

[18] During 2003, most corporate tax functions of public companies began to implement the provisions of section 404 of the Act dealing with documentation and testing of internal controls around matters that could have a material adverse effect on the financial statements of the company. In general, tax departments and their auditors have relied upon substantive testing of their tax provisions and tax return audits by tax authorities to validate the amounts recorded as tax expense in the financial statements rather than testing internal controls within the tax function. Now, as the implementation date for section 404 of the Act looms on the horizon, tax

departments must develop documentation and testing procedures around their internal control processes which are designed to avoid material misstatements of the financial statements. In most cases, this new compliance burden is falling on the already resource- strained tax departments. With the requirement to extend this documentation and assertion process to financial statement disclosures as well under section 302 of the Act, tax departments are having to shift resources from tax planning activities to respond to the new compliance requirements. This situation may well be further exacerbated if the National Association of Insurance Commissioners (NAIC) issues provisions, currently under consideration, similar to those resulting from Sarbanes-Oxley that would be applicable to all insurance companies.

Ways and Means Committee Passes H.R. 2896, the American Jobs Creation Act of 2003 and Senate Finance Committee Passes S. 1637, JOBS Act

[19] **Citations:** H.R. 2896, the American Jobs Creation Act of 2003 (H. Rept. No. 108-393) (July 25, 2003). For the full text, see *Doc 2003-25263 (255 original pages)* [**PDF**] or *2003 TNT 227-15*. S. 1637, the Jumpstart Our Business Strength Act of 2003 (S. Rept. 108-192) (Nov. 7, 2003). For the full text, see *Doc 2003-24262 (378 original pages)* [**PDF**] or *2003 TNT 218-19*.

[20] **Overview:** The House Ways and Means Committee and the Senate Finance Committee passed separate bills that would dismantle the Extraterritorial Income Exclusion Act (ETI), which the World Trade Organization (WTO) has ruled is an illegal export subsidy. Both bills would replace the ETI with a variety of international tax reforms as well as tax breaks for domestic manufacturers. Both bills also include revenue raising provisions.

[21] **Discussion:** All has been quiet on the legislative front this year, at least from an insurance industry perspective. As we noted in our Halftime Report, no insurance-specific proposals survived in the final version of the tax cut package that President Bush signed in May (see H.R. 2, *Doc 2003-13102 (17 original pages)* [**PDF**] or *2003 TNT 102-7*). Since then, congressional consideration of tax measures affecting the industry has been virtually non-existent.

[22] H.R. 2896, the Ways and Means's Committee's ETI repeal bill, is the only substantive legislative package currently before Congress that contains any insurance-related provisions -- and those are relatively minor. Section 3029 of the bill (proposing changes to the qualification rules for tax-exempt property and casualty insurers) and section 2004 (clarifying the rules for recharacterization of reinsurance transactions under Internal Revenue Code section 845) are similar (if not identical) to provisions that were considered for, but not included in, the tax cut package enacted this past spring. Section 3030 of the bill attempts to incorporate a definition of an insurance company under code section 831; however, the proposal merely applies the existing language of code section 816(a) to section 831 and offers no new guidance. An item of general interest in H.R. 2896 is that the temporary five-year carryback of net operating losses (NOLs) and suspension of the limitation on Alternative Minimum Tax NOLs would be extended for NOLs incurred in 2003.

[23] The Senate Finance Committee's ETI repeal bill, S. 1637, does not address insurance issues. It does, however, propose a number of provisions to curb abusive tax shelters -- including a provision that would codify the economic substance doctrine used by the courts. If

enacted, taxpayers would be required to show that a transaction changes their economic position in a meaningful way and has a substantial nontax purpose that is reasonably accomplished by entering into the transaction. (The Ways and Means Committee bill includes some anti-shelter provisions, but does not contain an economic substance requirement.)

[24] The House and Senate adjourned for the holidays without voting on their respective bills, but pressure is growing for lawmakers to act quickly. The European Union -- which brought the original complaint against the ETI to the WTO -- has threatened to impose trade sanctions of up to $4 billion a year against the United States if the ETI is not repealed by March 1, 2004. Perhaps Congress will strip one of the bills to a bare bones package, or perhaps miscellaneous tax law changes find their way into the bill. Only time will tell. However, the minimal attention Congress has paid the insurance industry on the tax legislative front in recent years seems to suggest that lawmakers are content to step back and allow the IRS and the courts (as shown in other portions of this article) to actively pursue matters important to the industry. Unlike Congress, there has certainly been no shortage of industry-related activity from those sectors this year. Is this the lesser of two evils? You decide.

Section II -- The Pronouncements

[25] Readers of our 2002 year-end report may recall that the insurance industry witnessed a great deal of activity in the courts - - e.g., *Best Life, Principal Mutual, State Farm, Trigon, Equitable Life, etc.* In 2003, the bulk of activity shifted from the courts to the IRS National Office and their attempt to increase the amount and timeliness of guidance issued. Read through our summary and comments regarding the key documents released in 2003 and judge for yourself as to whether more is always better.

Life Insurance Company Issues

Short-Term Capital Gain Must Be Included in Segregated Account's Gross Investment Income

[26] **Citations:** TAM 200330002 (Dec. 12, 2002). For the full text, see *The Insurance Tax Review*, September 2003, p. 479; *Doc 2003-17442 (12 original pages);* or *2003 TNT 144-27* .

[27] **Overview:** The Service ruled in technical advice memorandum 200330002 that an insurer must include short-term capital gains in a segregated asset account's gross investment income under section 812 and cannot exclude the gains through the reserve and basis adjustment rules of section 817.

[28] **Discussion:** The intricacies of the taxation of variable life insurance and variable annuity contracts (variable contracts) under section 817 combined with the taxation of mutual funds as regulated investment companies under subchapter M of the Internal Revenue Code makes for some heavy reading. Layer in the computation of the company share under section 812 and hopefully you don't feel dizzy. For all of this complexity, in the end it is easy to summarize the Service's position: subchapter M governs the characterization of amounts distributed by mutual funds that support variable contracts. Accordingly, amounts distributed by the mutual funds are characterized as either long-term capital gains or ordinary dividend income, and some of the latter category may be eligible for treatment as qualifying dividends for the dividends received deduction.

[29] If the world were just so simple, the taxation of insurance companies would be far easier to deal with (and some of us might be flipping burgers for a living). However, the taxation of insurance companies -- especially life insurance companies -- has been an ever-changing menagerie of specialized rules to deal with the unique characteristics of the underlying products sold. The world of variable contracts is no different. This case in point deals with the Service's lack of consideration of the specialized tax accounting rules dealing with the distributions received by life insurance companies from mutual funds supporting variable contracts. If such contracts qualify as variable contracts under section 817(c), the code requires the life insurance company to utilize a form of mark- to-market accounting for the investment in the mutual funds. Accordingly, the life insurance company recognizes any gains and losses in the mutual fund's investment portfolio when they first occur, not when they are recognized by the mutual fund in the year the investment is disposed of. So the receipt of a distribution from the mutual fund (that is determined utilizing historical cost data at the mutual fund level) creates a significant mismatch, and dilemma, for the life insurance company: how to treat for federal income tax purposes an amount that has already been reported in taxable income, yet is reported as a taxable distribution from the mutual fund? Unfortunately, the Service did not carry its analysis all the way through to consider the tax accounting issues at the life insurance company level, and settled for the "simple" solution in a complicated situation. Therefore, life insurance companies are faced with either accepting the Service's position and the resultant double counting of income or forging ahead with a more comprehensive solution that will likely be the subject of future disagreements with the Service's National Office.

Life-Nonlife Group Determines Charitable Deductions on Subgroup Basis

[30] **Citations:** TAM 200323002 (Jan. 31, 2003). For the full text, see *The Insurance Tax Review*, July 2003, p. 138; *Doc 2003-13802* (*7 original pages*); or *2003 TNT 110- 7*.

[31] **Overview:** The Service ruled that in a life-nonlife consolidated group, each subgroup must determine the subgroup's consolidated charitable contribution deduction limitation based on the subgroup's adjusted consolidated taxable income.

[32] **Discussion:** Once again, the Service has fallen back upon the subgroup methodology established in regulation section 1.1502-47 to deny a life-nonlife group of companies a true consolidated return result. Although this answer may be defensible, it is not necessarily correct, and it does open the door to contribution "planning" in situations where one of the subgroups is in a loss position.

Insurance Company Expenses Are Deductible

[33] **Citations:** TAM 200334005 (Apr. 16, 2003). For the full text, see *The Insurance Tax Review*, October 2003, p. 646; *Doc 2003-19125* (9 *original pages*); or *2003 TNT 164- 10*.

[34] **Overview:** The Service ruled that expenses incurred by a taxpayer to diversify its insurance and annuity products are deductible as ordinary and necessary business expenses.

[35] **Discussion:** Here, expenses relating to the introduction of new insurance and annuity products and to the expansion of the taxpayer's network of independent insurance agents

were deductible as ordinary and necessary business expenses, rather than treated as capital expenditures. This ruling reiterates the discussions in the legislative history that initial selling expenses of insurance companies are currently deductible and follows in the footsteps of ILM 200220006, in which the Service concluded that section 848 trumped the application of section 263 in allowing an insurer to deduct expenses for developing a new product. While the Service and Treasury have been busy developing new requirements around the capitalization of expenses in the wake of *INDOPCO*, it is refreshing to find them retaining the historical and fundamental treatment of expenses in the insurance industry, therefore choosing to not pursue the path of challenging this longstanding industry treatment.

Actuarial Guideline May Not Be Used for Pre-Existing Annuity Contracts

[36] **Citations:** TAM200328006 (Mar. 20, 2003). For the full text, see *The Insurance Tax Review*, September 2003, p. 489; *Doc 2003-16406 (3 original pages) [**PDF**];* or *2003 TNT 134-6* .

[37] **Overview:** In technical advice, the Service concluded that a life insurance company may not calculate the tax reserves of annuity contracts using an actuarial guideline that took effect after the issuance of the contracts.

[38] **Discussion:** The issue revolves around Actuarial Guideline XXXIII, Determining CARVM (Commissioners' Annuities Reserve Valuation Method) Reserves for Annuity Contracts with Elective Benefits (AG 33), which was issued to take effect on December 31, 1995 for all contracts issued on or after January 1, 1981. The introduction to AG 33 states that "the major purpose of this Actuarial Guideline is to provide clarification and consistency in applying CARVM. . . ." Therefore, one can easily read AG 33 as providing written clarification of how companies should have been applying CARVM to contracts issued since 1981. However, the Service has interpreted AG 33 in a much stricter sense as inapplicable to contracts issued prior to December 31, 1995, since it was not part of CARVM prior to this date and since section 807(d)(3)(B)(ii) requires the use of the CARVM methodology that is in effect on the contract's date of issuance.

[39] What we have here is a definitional issue that will be the source of disagreement between the insurance industry and Service for some time to come: what constitutes a reserving method? (For those of you old enough to remember, think about the definitional issues around renewable term policies and prior-law section 818(c) and whether they were a single contract or a series of one-year contracts.) In any case, section 807 requires the use of a specific reserving method in effect at a point in time as prescribed by the National Association of Insurance Commissioners (NAIC).

[40] It appears that while the code relies upon the NAIC to define what the reserving methodologies are, the Service has drawn what appears to be a "bright-line" -- that actuarial guidelines issued by the NAIC delineate a change in a reserve method that can be applied only prospectively to contracts issued after the date the clarification is issued -- even though the NAIC treats the guideline as a written clarification of a methodology already in place. The Service relies upon a discussion in the legislative history to reach this conclusion regarding the status of the CARVM methodology in 1984 dealing with surrender charges. Only time will tell whether the Service's bright-line can be sustained or whether the Service will eventually

recognize a more traditional application of the NAIC's definition of reserving methodology.

IRS Unveils New Software to Analyze Life Insurers' Reserves

[41] **Citations:** For news coverage, see *The Insurance Tax Review*, November 2003, p. 724; *Doc 2003-20952 (2 original pages)* [**PDF**]; or *2003 TNT 184-5* .

[42] **Overview:** At a financial services industry conference, IRS officials discussed the new actuarial software the Service will be using to analyze life insurance companies' tax reserves.

[43] **Discussion:** The Service hopes to use this off-the- shelf software product, instead of outside actuaries, to audit life insurance reserves. While this would seem to make sense initially, one wonders just how user friendly this software is and how effective the training will be. If it is as easy to use as public commentary would indicate, one would wonder why more companies do not use the product to compute both their statutory and tax reserves. In the real world, companies often find that using an off-the-shelf product requires significant involvement on the part of actuarial and information technology professionals in order to adapt the product to the company's particular circumstances. The big question thus becomes whether the Service's "one size fits all" approach will lead to issues being raised where there are no substantive questions. Early indications suggest that there are implementation issues and that these have led in some instance to an excessive burden on the taxpayer. Mere mortals should tread lightly in the land of actuaries.

Negative Excess Recomputed Differential Earnings Not Deductible

[44] **Citations:** *John Hancock Financial Services, Inc. and John Hancock Life Insurance Company v. The United States,* No. 01-543T (Fed. Cl. July 15, 2003). For the full text, see *The Insurance Tax Review*, September 2003, p. 455; *Doc 2003-16747 (7 original pages) [**PDF**];* or *2003 TNT 137-31*  .

[45] **Overview:** The Court of Federal Claims held that an insurance company may not exclude recomputed differential earnings (RDE) amounts not allowable as deductions from future income, and the negative excess RDE amounts are not amounts deducted in an earlier year under section 111.

[46] **Discussion:** At first blush, there is nothing new here, since three U.S. Courts of Appeals have upheld the government's disallowance of increased policyholder dividends associated with negative recomputed differential earnings rates (*CUNA Mutual Life Insurance Co. v. United States,* 169 F.3d 737 (Fed. Cir. 1999), *Indianapolis Life Insurance Co. v. United States,* 115 F.3d 430 (7th Cir. 1997), and *American Mutual Life Insurance Co. v United States,* 43 F.3d 1172 (8th Cir. 1994). However, John Hancock accepted these decisions and proposed recovery based on a different theory involving the "tax benefit rule" on the basis that it should be allowed to exclude income associated with the disallowed deductions. The court agreed that section 809 may result in transaction inequities; however, allowing the tax benefit rule to apply would constitute an "end-run" around now well-settled law that disallows recognition of any deductions based on the negative recomputed differential earnings rates.

[47] The court's brief discussion of the tax benefit rule adds to the body of law around application of this important judicial concept to the insurance industry. The court agreed with the government's position that the recomputed differential earnings amount calculated in tax years subsequent to 1986, even though impacted by the 1986 calculations, cannot be considered "recoveries" during those tax years for purposes of the tax benefit rule. The court noted that the U.S. Supreme Court has recognized that a recovery is not always necessary to invoke the tax benefit rule, but that there must be a subsequent event. The court found that no event occurred subsequent to 1986 -- rather, only an imputation of income calculated in accordance with section 809 -- and that to allow John Hancock's position would place it in direct conflict with the plain language of the governing statute. Accordingly, the specialized tax accounting provisions of subchapter L for insurance companies may afford both opportunities -- such as in the case of *Allstate Insurance Co. v. United States*, 936 F.2d 1271 (Fed. Cir. 1991), dealing with subrogation recoveries -- and denials in the case of section 809 and the negative excess recomputed differential earnings amount.

"Amount Retained" for Interest Calculations Addressed

[48] **Citations:** TAM200339049 (Aug. 20, 2002). For the full text, see *The Insurance Tax Review*, November 2003, p. 781; *Doc 2003-21179 (11 original pages)* [**PDF**]; or *2003 TNT 188- 10* .

[49] **Overview:** In technical advice, the Service concluded that the "amount retained" under regulation section 1.801- 8(e)(1) includes the contractual charges and fees subtracted from separate accounts that support two life insurance companies' respective variable annuity contracts.

[50] **Discussion:** This was very welcome and timely guidance from the Service and helps to settle an issue on which revenue agents have spent considerable time during various examinations of life insurance companies. The key focus here is that the Service allowed required contractual fees that are charged against the separate account values of the variable contracts to be treated as the retention of a portion of the investment income earned (i.e., amount retained) by the separate account in computing the company's share under section 812. Conversely, the Service found that contingent deferred sales charges, collected at the time of a withdrawal or surrender (otherwise known as surrender charge), are not part of the amount retained since they are required to be taken into taxable income through the reserve deduction in the year in which premium contributions are received.

[51] Once again, the Service has looked back to prior law as the basis for its ruling. Since much of the Deficit Reduction Act of 1984 dealing with life insurance companies was founded on the 1959 Life Insurance Company Tax Act, it is refreshing to see the Service continue to stay the course and carry forward the concepts that are the foundation of much of the current tax treatment of life insurance companies.

Required Interest Calculation Outlined for Life Insurance Companies

[52] **Citations:** Rev. Rul. 2003-120, 2003-48 IRB 1154. For the full text, see *Doc 2003-25476 (2 original pages) [**PDF**]; 2003 TNT 230-13* ; or p. 233.

[53] **Overview:** The Service determined that "required interest" under section 812(b)(2)(A) is calculated using the mean of the amount of the reserve at the beginning of the tax year and the amount of the reserve at the end of the tax year.

[54] **Discussion:** Just like it did in its ruling on the amount retained (discussed above), the Service has restated under current law that the provisions of prior law dealing with the computation of required interest carry forward. Section 812(b)(2) provides no guidance, other than the interest rates, regarding how required interest is to be computed, so the Service reached back to prior law. For now, it seems clear that the provisions of prior-law section 809 dealing with required interest (and the body of law surrounding this more than 40-year-old provision) are equally applicable to the computations under current law section 812.

Life Insurance Group May Restructure Its Holdings

[55] **Citations:** LTR 200302022 (Sept. 30, 2002). For the full text, see *The Insurance Tax Review*, March 2003, p. 439; *Doc 2003-1132 (4 original pages)* [**PDF**]; or *2003 TNT 8-46*.

[56] **Overview:** The Service ruled that a consolidated group and its life-nonlife election will remain in existence after it restructures its holdings.

[57] **Discussion:** In the current state of the industry with numerous acquisitions and dispositions, many groups have corporate structures that do not match their corporate governance structure. This ruling clearly indicates that a well thought out structure and regulatory requirements can be helpful in achieving a realignment of the corporate structure in a tax-efficient manner even if the group includes life insurance companies.

Property and Casualty Insurance Company Issues

Partial Relief from Retroactive Application of Guidance Granted

[58] **Citations:** TAM 200330009 (Oct. 22, 2002). For the full text, see *The Insurance Tax Review*, September 2003, p. 486; *Doc 2003-17449 (6 original pages*); or *2003 TNT 144- 28*.

[59] **Overview:** The Service concluded that the determination of an earlier memorandum on retrospectively rated insurance policies should be applied, in part, without retroactive effect.

[60] **Discussion:** In a 2001 TAM dealing with tax years prior to 2001, the Service concluded that the taxpayer was required to take into account both retro debits and retro credits related to the expired portion of policies that had not terminated as of end of the year in computing premium income. The retro debits were to be included in gross premiums written and the retro credits were to be included in unearned premiums. The positions taken by the Service differed from the positions taken in a 1967 TAM relating to the same taxpayer. Accordingly, the taxpayer asked the Service for relief from retroactive application of its 2001 TAM. The Service allowed retroactive relief relating to one of the two issues dealt with in the 2001 TAM; however, with respect to the taxpayer's arguments regarding the netting of retro debits and retro credits in pre-2001 tax years, the Service denied relief from retroactive application of the 2001 TAM. While the revised regulation under regulation section 1.832-4 eliminates the uncertainty regarding the treatment of retro debits and retro credits in 2001 and later years, this TAM is a good reminder that the "gray matter" areas of the insurance tax law have unknown hazards

that come to light many years after the taxpayer must file its tax return.

IRS Issues Guidance on Discontinuing Deduction for Insurers' Special Estimated Tax Payments

[61] **Citations:** Rev. Rul. 2003-34, 2003-17 IRB 813. For the full text, see *The Insurance Tax Review*, June 2003, p. 960; *Doc 2003-10573 (1 original page)* [**PDF**]; or *2003 TNT 81- 65*.

[62] **Overview:** The IRS ruled that an insurance company taking a section 847 deduction in one year is not required to ask permission to stop taking a section 847 deduction in a subsequent year.

[63] **Discussion:** The Service's position is consistent with the longstanding tradition that each accident year stands on its own and the claiming of a deduction pursuant to section 847 is not equivalent to an election of a method of accounting. The section 847 deduction attaches to a specific accident year and does not achieve the level of a general method of accounting, much in the same way that the election to utilize company payment patterns under section 846(e) attaches only to specific accident years.

Blue Cross and Blue Shield Issues

[64] As we noted in our 2003 Halftime Report, several Blue Cross and Blue Shield organizations found themselves in court after having their claims rejected. While the litigation process finally came to a conclusion in the *Trigon, Blue Cross & Blue Shield of Texas,* and *Blue Cross & Blue Shield United of Wisconsin* cases, we are still holding our breath on *Capital Blue Cross*.

District Court Denies Trigon's Motion to Alter Judgment in Cancelled Contracts Case

[65] **Citations:** *Trigon Insurance Co. v. United States*, No. 3:00cv365 (E.D. Va. Dec. 17, 2002). For the full text, see *The Insurance Tax Review*, February 2003, p. 250*; Doc 2003-939 (11 original pages) [**PDF**];* or *2003 TNT 6-10*.

[66] **Overview:** A U.S. district court refused to alter or amend its judgment that Trigon Health Insurance Co. cannot deduct carryover losses from cancelled subscription and provider contracts because the company did not meet its burden of proof in valuing the contracts.

[67] **Discussion:** The refusal of the district court to upset the factual findings in its initial opinion in this case highlights the evidentiary standards that courts will apply in refund cases involving valuations. Essentially, even though a taxpayer need not provide an exact valuation amount, it must be able to provide at least a basis upon which a court can make a reasonable estimate. Unfortunately for the taxpayer in this case, the harsh result of its inability to meet this standard was that it was not entitled to any recovery despite the court's agreement with its substantive legal arguments.

[68] The fact that the court reiterated its agreement with the taxpayer's legal theory relative to the ability to deduct losses resulting from the cancellation of subscriber contracts may, however, prove useful to other taxpayers with similar issues. In particular, Capital Blue Cross currently awaits the Tax Court's decision in its case dealing with the same legal questions. Whether Capital Blue Cross met the appropriate evidentiary standard remains to be seen. Discussions among industry professionals relating to this litigation, however, indicate that the taxpayer provided the court with a basis for valuation supported by compelling factual evidence and highly qualified expert testimony. A decision in this case is expected to be rendered early in 2004.

[69] It also should be noted that members of the Service have publicly stated that, depending on the result in *Capital Blue Cross*, the IRS might revisit its decision -- made in 2000 -- to not settle cases on this issue.

Blue Cross & Blue Shield Not Entitled to Deduction for Estimated Salvage Recoverable

[70] **Citations:** *Blue Cross & Blue Shield of Texas Inc., et al. v. Commissioner,* No. 02-60188 (5th Cir. Apr. 16, 2003). For the full text, see *The Insurance Tax Review*, June 2003, p. 934; *Doc 2003-9959 (28 original pages) [**PDF**];* or *2003 TNT 76-19* .

[71] **Overview:** The Fifth Circuit, affirming the Tax Court, held that Blue Cross & Blue Shield of Texas is not allowed to take special deductions for estimated salvage recoverable on coordination of benefits (COB) savings.

[72] **Discussion:** The court found that estimated salvage recoverable does not include COB savings under the "pursue and pay" approach because there is no expectation of recovery or payment of the full amount of claims and, accordingly, no corresponding salvage right. As we observed in 1997 in our analysis of technical advice released that year on a similar issue,[2] a central focus of the Service's position (and now the Fifth Circuit's holding) is that under the pursue and pay approach, the taxpayer's secondary liability is extinguished by payment of the claim by the primary insurer, whereas under a pay and pursue arrangement the taxpayer pays the claim (creating a liability in the mind of the Service), and then seeks recovery from the primary insurer.

[73] The number of companies concerned with the special deduction at issue here continues to dwindle with the passage of time. This case, however, similar to the 1997 TAM, is significant not only for Blue Cross/Blue Shield organizations, but also for any insurance company subject to the salvage and subrogation rules of section 832 for the glimpse it provides into what will be treated as salvage and subrogation.

Insurance Company Must Use Annual Report to Determine Deduction

[74] **Citations:** *Blue Cross & Blue Shield United of Wisconsin, et al. v. United States*, No. 98-727T (Fed. Cl. June 12, 2003). For the full text see *Doc 2003-15036 (31 original pages)* [**PDF**] or *2003 TNT 120-19* .

[75] **Overview:** The Court of Federal Claims held that sections 832 and 846 require that the actuarial estimate of an insurance company's unpaid loss reserve as of December 31, 1986, as shown on its annual report, be employed to calculate the 1987 section 832(c)(4) deduction.

[76] **Discussion:** This decision reflects yet another area where questions continue to linger surrounding the transition of Blue Cross and Blue Shield organizations to taxable status. In this particular case, the court found the taxpayer unable to support its position that the generally applicable statutory provisions relating to the calculation of tax reserves should not prevail. However, the case is also interesting reading for all taxpayers and their advisors with regards to the force and effect that provisions in closing agreements between taxpayers and the Service have in resolving future disagreements. Here, the taxpayer attempted to convince the court that certain provisions of a prior tax year closing agreement should override the application of the code in computing taxable income. The court disagreed with the taxpayer's interpretation of the closing agreement and held them bound by the clear requirements of the code under section 846.

IRS Intends to Define Commercial-Type Insurance

[77] **Citations:** Notice 2003-31, 2003-21 IRB 948. For the full text, see *The Insurance Tax Review*, June 2003, p. 962; *Doc 2003-11459 (5 original pages) [**PDF**];* or *2003 TNT 89-21*. ILM 200318006. For the full text, see *Doc 2003-11460 (2 original pages)* [**PDF**] or *2003 TNT 89-22*.

[78] **Overview:** The Service announced its intention to propose regulations that define commercial-type insurance under section 501(m), and address how that section applies to organizations described in sections 501(c)(3) and 501(c)(4), including HMOs.

[79] **Discussion:** For some time now, the lack of a clear definition as to what is commercial-type insurance has caused uncertainty as to the proper tax status of a number of organizations, including many HMOs. The Service's withdrawal of parts of the Internal Revenue Manual Guidelines regarding section 501(m) only heightens the uncertainty. What will be interesting to follow is how the Service will define commercial-type insurance. Will it attempt to write its own definition of insurance or will it leave this task up to the courts and try to delineate where a transaction crosses over the line and becomes a commercial-type contract? Only time will tell, but there is a significant segment of the health care industry that is watching. The whole insurance industry should also be watching in order to make sure the Service does not resolve one issue and create new ones for other segments of the industry.

Noninsurance Issues

[80] Although the number of current developments involving noninsurance tax issues is too voluminous to discuss, two developing areas are of particular interest. In one case, it demonstrates the Service's desire to provide timely guidance, or potentially plug a hole, based upon a series of court decisions. The other development involves a notice issued by the Service regarding an unexplored area where guidance is sorely needed.

MACRS Classification Change Is Not Change in Accounting Method

[81] **Citations:** T.D. 9105 (Dec. 30, 2003). For the full text, see *Doc 2003-27154 (32 original pages)* [**PDF**] or *2003 TNT 250-2*. *Commissioner v. Brookshire Brothers Holding, Inc.*, 320 F. 3d 507 (5th Cir. 2003). For the full text, see *Doc 2003- 2789 (18 original pages)* [**PDF**] or *2003 TNT 21-16*. *Green Forest Manufacturing Inc. v. Commissioner*, T.C. Memo 2003-75, No. 1596-01. For the full text, see *Doc 2003-6840 (13 original page s)* or *2003 TNT 51-1*. *Roger O'Shaughnessy, et al v. Commissioner*. 332 F.3d 1125 (8th Cir. June 13, 2003). For the full text, see *Doc 2003-14490 (12 original pages)* [**PDF**] or *2003 TNT 115-4*.

[82] **Overview:** The Service issued temporary and proposed regulations on whether a change in depreciation or amortization is a change in method of accounting under section 446(e).

[83] **Discussion:** A continuing area of discussion among insurance tax professionals has been what constitutes a change in method of accounting. While depreciation expense for most insurance companies pales in comparison with their various underwriting deductions, it does affect almost every company in the industry. During 2003, three courts -- including two circuits -- reacted favorably to the taxpayer position that a change in a depreciation method was not a change in method of accounting. It is interesting to see how quickly Treasury and the Service reacted to these decisions culminating with the release of the temporary and proposed regulations.

[84] The issue facing the courts in each of these cases dealt with an accounting issue involving the reclassification of property under the modified accelerated cost recovery system (MACRS) (i.e., the reclassification of property originally classified as 15-year property to five years, resulting in a significant catch-up adjustment). The Tax Court had previously held in *Brookshire Brothers* and *Green Forest Mfg*. that a reclassification under MACRS is not a change of accounting method even though it results in a new recovery period or depreciation method. The Fifth Circuit agreed in *Brookshire Bros.*, and the Eighth Circuit recently agreed in *O'Shaughnessy* (appealed from a district court). The IRS did not appeal the decision in *Green Forest Mfg.* to the Ninth Circuit, deciding instead to focus on developing administrative guidance. On December 30, the IRS released the temporary and proposed regulations as a result of these court decisions which, in effect, rewrite the regulations that were the foundation of the *Brookshire Brothers* decision (i.e., the existing regulations stated that a change in method does not include "an adjustment in the useful life of a depreciable asset").

IRS Issues Guidance on Identifying Built-In Items Through Safe Harbors

[85] **Citations:** Notice 2003-65, 2003-40 IRB 747. For the full text, see *Doc 2003-20406 (20 original pages)* [**PDF**] or *2003 TNT 178-14*.

[86] **Overview:** The Service issued guidance specifying two safe harbor methods for identifying built-in items under section 382(h).

[87] **Discussion:** One area that has become more prevalent in a number of acquisitions within the insurance industry has been section 382 and the limitation on net operating losses of the target company. While Notice 2003-65 does not give specific guidance for some of the unique issues that arise in the insurance company context, it is helpful in establishing a framework for analyzing the target company's factual situation. The notice sets forth two safe harbor approaches for identifying built-in items: the section 1374 approach (the 1374 Approach) and

the section 338 approach (the 338 Approach). Taxpayers may rely on the approaches contained in the notice for a change of control occurring at any time prior to the issuance of temporary or final regulations under section 382(h). Taxpayers may use either the 1374 Approach or the 338 Approach, but not elements of both, for each ownership change with respect to a loss corporation or a loss subgroup as defined in regulation section 1.1502-91(d).

Conclusion -- A Look Ahead

[88] Five or ten years from now, insurance tax professionals may look back on 2003 as a year in which a number of new tax issues were brought to the forefront across the industry. Only time will tell how these will play out. When analyzing the 2003 developments, one quickly realizes that most, but not all, relate to new types of products developed since the life insurance and property and casualty tax rules were last rewritten almost 20 years ago. Due in part to the structure of subchapter L's insurance tax rules, which in most cases focus more on the type of product involved as opposed to the form of license of the issuing company, the outcome of many of these issues will have broad impact across the industry, although some segments will feel more of an impact than others.

[89] The Service's drive to provide more timely guidance is welcome news in an industry where numerous areas still lack official guidance. This is due in part to the complex nature of the insurance industry and, not unexpectedly, to the fact that both sides do not always agree on what the right answer is. (Sounds a little like how actuaries set the level of reserves.) Further, in a world where there is now a microscopic focus on public company earnings and disclosures, tax controversies have become more visible. Consequently, disclosures regarding disagreements between a taxpayer and the Service over the treatment of specific items, if material to the company's financial statements, now are subject to more scrutiny from the investing public. Thus, a complete understanding of the impact of the issues raised in 2003 becomes even more important, and, given the increase in scope, more difficult to accomplish, especially when tax professionals are being pulled in multiple directions both internally and externally.

FOOTNOTES

[1]*See* J. Howard Stecker, Gregory L. Stephenson, and Frederic J. Gelfond, "Halftime 2003 -- Selected Insurance Tax Developments," *Ins. Tax Rev.,* Aug. 2003, p. 233.

[2]*See* Howard Stecker and Clint Stretch, "Tax Story: 1997 and Beyond . . . , Part I -- Federal Insurance Tax Issues," *Ins. Tax Rev.*, Mar. 1998, p. 389, at 400, and TAM 9717009, *Ins. Tax Rev.*, June 1997, p. 1057; *Doc 97-11609 (24 pages);* or *97 TNT 81-13* .

END OF FOOTNOTES

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Code Section: Section 801 -- Life Insurance Company Tax
Geographic Identifier: United States

Subject Area: Insurance company taxation
Industry Group: Insurance
Author: Burness, Richard J.; Stephenson, Gregory L.; Stecker, J. Howard
Institutional Author: Deloitte & Touche
Tax Analysts Document Number: Doc 2004-620 (10 original pages) [PDF]
Tax Analysts Electronic Citation: 2004 TNT 38-59