

Office of Chief Counsel
Internal Revenue Service
Memorandum

Release Number: **20072501F**

Release Date: 6/22/07

CC:LM:F:HAR:POSTF-119181-07

JFLong

UILC 847.00-00

date: May 10, 2007

to: Appeal Officer
IRS Appeals

from: Joseph F. Long
Senior Attorney
(Large & Mid-Size Business)

subject:

LEGEND:

Taxpayer =

Acquiring Company =

Date 1 =

Year 1 =

Year 2 =

Year 3 =

Amount 1 =

This is in response to your request for our advice concerning I.R.C. § 847. This document should not be used or cited as precedent.

ISSUE

The Taxpayer decided not to claim the I.R.C. § 847 deduction for the taxable year ended Date 1, and accordingly did not make a special estimated tax payment for that year. The question is when can the Taxpayer get a refund of special estimated tax payments paid in prior years that are not used to pay tax liabilities?

FACTS

The salient facts are that Taxpayer elected to take advantage of the tax deduction allowed by I.R.C. § 847 beginning in Year 1 by making the special estimated tax payments (SETP) for that year. Taxpayer continued to make the election until its last short tax year ended on Date1. Also on Date 1 Taxpayer was acquired by a subsidiary of Acquiring Company in a reverse triangular merger acquisition subject to I.R.C. § 381(a). Taxpayer continues to exist and operate as an insurance company as a subsidiary of Acquiring Company. On Date 1, Taxpayer had a net operating loss (NOL) which was partially utilized in Year 2 and Year 3. The remainder of the NOL was carried over to the Acquiring Company.

Taxpayer's position is that on Date 1 it takes into gross income the entire balance in the special loss discount account (SLDA). SETPs are then used to pay the additional tax resulting from inclusion of the SLDA amount in gross income. After said additional tax liabilities are paid, there is still a balance left in SETP account. Taxpayer argues that it is entitled to an immediate refund of all SETPs.

ANALYSIS

Prior to the Tax Reform Act of 1986, property and casualty insurance companies generally were allowed to deduct the full amount of their unpaid losses in calculating taxable income. Due to Congressional concern that these companies were overstating their current deductions for future loss payments, the Tax Reform Act of 1986 provided for discounting of unpaid losses. I.R.C. § 832 requires that these taxpayers discount their deductions for insurance loss reserves. Now, before a deduction for loss reserves can be claimed, the unpaid losses must be discounted under I.R.C. § 846 in order to account for the time value of money. The deduction for unpaid losses¹ under I.R.C. § 846 is limited to the amount of discounted unpaid losses.² This amount is the sum of the discounted unpaid losses separately computed with respect to unpaid losses in each line of business attributable to each accident year.³ The amount is computed by

¹ These are reported losses that have not been paid, estimates of losses incurred but not reported, resisted claims and unpaid loss adjustment expenses. These losses are separately computed by each accident year. I.R.C. § 846(a)(1).

² See I.R.C. § 846(a). See e.g., Rev. Proc. 99-36; Rev. Proc. 99-15.

³ Accident year means the calendar year in which the incident occurs that gives rise to the related unpaid loss. I.R.C. § 846(a)(1).

using the amount of the undiscounted unpaid losses, the applicable interest rate, and the applicable loss payment pattern. I.R.C. § 846(a)(2).

Under I.R.C. § 847, for taxable years beginning after December 31, 1987, an insurance company required to discount unpaid losses may elect⁴ to take a deduction, not to exceed the excess of the undiscounted unpaid losses over the related discounted unpaid losses at the end of the year, *i.e.*, a deduction equal to the amount of the discount. By claiming a deduction for discounted losses in accordance with I.R.C. § 846 and the additional deduction for the amount of the discount under I.R.C. § 847, the Taxpayer, in essence, is deducting its full, undiscounted, reserve for losses. In order to be eligible to take the deduction under I.R.C. § 847, the Taxpayer must make SETPs as discussed below.

The amount of the I.R.C. § 847 deduction in the first year is to be added to a SLDA. I.R.C. § 847(3). For each year thereafter, an amount equal to the amount allowed as a deduction for that taxable year is to be added to the SLDA. I.R.C. § 847(4). In subsequent years as losses are paid and the related discount declines, a corresponding amount is to be subtracted from the SLDA and included in the company's gross income. I.R.C. § 847(5)(A) and (B). To the extent that any amount added to the SLDA is not subtracted from the SLDA before the 15th year following the year for which the amount was added to the SLDA, the amount will be subtracted from the SLDA and included in gross income in said year. I.R.C. § 847(5).⁵

Any additional tax liability resulting from the inclusion of the amounts from the SLDA in gross income is offset by previously made SETP. If after the payment is applied there is an adjustment reducing the amount of the additional tax, in lieu of any credit or refund for such reduction, a SETP will be treated as made in an amount equal to the amount otherwise allowable as a credit or refund.⁶ To the extent the SETP are

⁴ An insurance company electing to take a deduction under I.R.C. § 847 does not need the Commissioner's permission to discontinue claiming an I.R.C. § 847 deduction in a later year. Rev. Rul. 2003-34, 2003-1 C.B. 813.

⁵ If a company liquidates or otherwise terminates its business and does not transfer or distribute such business in an I.R.C. § 381 acquisition, the entire amount remaining in the special loss discount account is subtracted and included in gross income. In addition, except for an I.R.C. § 381(a) acquisition, if the company is not taxed under I.R.C. §§ 801 or 831 for any taxable year, the entire amount remaining in the account at the close of the preceding taxable year is subtracted from the account in that year and included in gross income. I.R.C. § 847(6)(A).

⁶ The regular estimated tax payments under I.R.C. § 6655 are determined without regard to the deduction allowed under I.R.C. § 847.

not used to offset additional taxes during the 15 years following the year for which the payment was made (which may occur if the company incurs net operating losses in those years), the unused amount will be treated as a regular estimated tax payment in the sixteenth year after the year for which a SETP was made. I.R.C. § 847(2). Accordingly, the SETP may be applied to pay income taxes due in the 16th year, or the amount may be refunded to the company. The first 15-year period for SETP made for the tax year 1988 expired in 2004.

I.R.C. § 847 was intended to be revenue neutral⁷ and was designed to offset the negative effects on financial accounting created by the discounting of unpaid losses required by I.R.C. § 846. This was viewed as having a significant impact upon financial statements prepared in accordance with generally accepted accounting principles (GAAP). However, this is no longer the case under current GAAP principles since financial accounting reporting rules changed after I.R.C. § 847 went into effect. Taxpayers today have found that I.R.C. § 847 provides them with an unintended tax benefit in certain states. The primary incentive for taxpayers to utilize this deduction is that it allows them to lower their state income tax liabilities in the states that recognize the I.R.C. § 847 deduction, *i.e.*, in states that use Federal taxable income as the starting point for determining state income taxes.

The LMSB audit team takes the position that SETP must be applied against a tax liability. Therefore, the Service allowed Taxpayer to use Amount 1 of the SETP to pay off the Amount 1 liability for Year 3. The Service contends the remaining SETP amounts can not be refunded until either there is a tax liability to offset it against, or until the sixteen years called for by I.R.C. §§ 847(2) and 847(5) have run out. In contrast, Appeals believes that, since the IRS never published the regulations specifically called for in the statute, the Taxpayer should be allowed an immediate refund of the entire SETP account.

We disagree with Appeals. Even when Congress expects that regulations will be enacted, the absence of regulations does not make the Code section ineffective. *Trans City Life Ins. Co. v. Commissioner*, 106 T.C. 274, 300 (1996). In our opinion, SETPs are only refunded when characterized as a estimated tax payment – either a special estimated tax payment refunded due to audit adjustments that affect the I.R.C. § 847 deduction, NOL carrybacks that reduce the I.R.C. § 847 deduction, or refunds of unused SETP in the sixteenth year that convert to regular estimated tax payments due to unreversed amounts in the SLDA. SETPs are treated as payments of tax within the meaning of I.R.C. § 6611(a), so the Service must generally pay interest on overpayments of SETP. I.R.C. § 847(2) provides certain rules for SETPs that have not been used to offset additional tax within 15 years from the date of payment. Additional limitations apply to payment of interest on refunds of these amounts. See, I.R.C.

⁷ H.R. Conf. Rep. No. 1104, 100th Cong. 2nd Sess.173 (1988)(TAMRA Conference Report).

§ 6611(e).⁸

Appeals believes the Service's position is inequitable asserting that failing to immediately refund the entire SETP balance amounts to an interest free, multi-year loan to the Government. It contends that this could not be what Congress intended. We disagree. Before enacting the SETP requirements of I.R.C. § 847, Congress originally proposed to achieve tax neutrality by requiring the insurance company to purchase non-interest bearing, prepaid tax certificates in the amount of the deduction. Something akin to the tax and loss bonds required by I.R.C. § 832(e). As enacted, I.R.C. § 847 is at least as equitable as the alternative of non-interest bearing prepaid tax certificates. Furthermore, I.R.C. § 847 clearly recognizes that in some circumstances the Taxpayer will never recover all of its special estimated tax payments. For example, in the event of liquidation or termination of the insurance business, the entire amount in the SLDA is included in gross income. Any SETP s remaining after credit is given for the tax resulting from including the entire SLDA in gross income is voided, and is not later available for credit or refund. I.R.C. § 847(6)(B); Kies, Kenneth J., A Technical Explanation of Section 847 – Guidance for the Taxpayer Engaged in the Property and Casualty Insurance Business, *The Insurance Tax Review*, November – December 1989. In the present circumstance, the Taxpayer is not forfeiting its SETP, but is merely required to wait until there is a tax liability to apply them against, or the sixteenth year as required by I.R.C. §§ 847(2) and 847(5). Finally, any benefit the Government receives from the "interest free loan" is offset by the additional tax deduction allowed by I.R.C. § 847.

CONCLUSION

In our opinion the Service's position is correct. Therefore, the Taxpayer is not entitled to an immediate refund of all SETPs.

If you have any questions, please contact _____ at _____

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By: _____
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⁸ Although it is by statute of no precedential value, (See, I.R.C. §§ 6110(b)(1)(A) and 6110(k)(3), and *Union Carbide Foreign Sales Corporation v. Commissioner*, 115 T.C. 423. fn 20), we note for informational purposes that IRS CCA 200118001; 2001 WL 47063 (IRS CCA) discusses interest on special estimated tax payments.