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INTERNAL REVENUE SERVICE
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OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR Associate Area Counsel, Area 1 (LM:FSH:HAR)
Attn: Joseph Long

FROM: Chief, Branch 4 (CC:FIP)

SUBJECT: Request for Technical Assistance Concerning the Proper
Treatment of Special Estimated Tax Payments
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On September 25, 2001, your office requested advice concerning the proper treatment of certain special estimated tax payments. In accordance with section 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

ISSUE:

Whether a property and casualty insurance company, which was a member of a consolidated group and a subsidiary of the common parent of the consolidated group, is entitled to the balance of special estimated taxes made pursuant to section 847 after leaving the consolidated group.

CONCLUSION:

The subsidiary retains the balance of the section 847 special estimated tax payments and must maintain its special estimated tax account.

FACTS:

Parent, a non-insurance company, is the common parent of a consolidated group. Sub, a property and casualty insurance company taxable under section 831(a), was a subsidiary of Parent and a member of the consolidated group from 1988 until December 31, 1998.

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For the tax years ending December 31, 1988 through December 31, 1998, Sub claimed a net section 847 deduction on Form 8816 of its individual pro-forma return as part of Parent's consolidated return. The special estimated tax payments were paid by Parent and were accounted for by the Service Center separately from Parent's other accounts.

On December 31, 1998, Sub was distributed to Parent's shareholders pursuant to section 355. At the time of the distribution, there was a net positive balance in the special estimated tax payment account.

LAW AND ANALYSIS:

Section 832(a) provides that, in the case of an insurance company subject to the tax imposed by section 831, the term "taxable income" means the gross income as defined in section 832(b)(1) less the deductions allowed by section 832(c).

Section 832(b)(1)(A) defines the term "gross income" to include the combined gross amount earned during the taxable year from investment income and from underwriting income as provided in section 832(b), computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners.

Section 832(b)(3) provides that the term "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

Section 832(b)(5) provides that the determination of "losses incurred" includes the net change during the taxable year of "discounted unpaid losses," as defined in section 846. Discounted unpaid losses are unpaid losses that are discounted to present value to account for the time value of money.

Section 847(1) permits an insurance company to deduct an amount, not to exceed the excess of the undiscounted unpaid losses (as defined in section 846(b)) over the amount of the related discounted unpaid losses (determined under section 846), to the extent not deducted in a prior taxable year. Section 847(2) allows the deduction under section 847(1) only to the extent the deduction results in a tax benefit in the current taxable year or carryback year, and only to the extent special estimated tax payments are made in an amount equal to the tax benefit attributable to such deduction.

Companies allowed a deduction under section 847(1) must establish and maintain a "special loss discount account." Section 847(3). Each taxable year, an amount equal to that year's deduction allowed under section 847(1) is added to this

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special loss discount account. Section 847(4). When companies pay losses in subsequent years, an amount equal to the excess of the special loss discount account with respect to losses incurred in each taxable year over the excess of the additional deduction allowed under section 847(1) is subtracted from the special account and included in the company's gross income. Section 847(5). If any tax is due as a result of such inclusion, an amount of the special tax payment shall be applied against such additional tax. Section 847(2). To the extent the special estimated tax payments are not used to offset additional taxes during the 15 years following the year for which the payment was made, the unused amount will be treated as a regular estimated tax payment made under section 6655 in the sixteenth year after the year for which a special estimated tax payment was made. Id.

If a company liquidates or otherwise terminates its insurance business and does not transfer or distribute such business in an acquisition of assets referred to in section 381(a), the entire amount remaining in such special loss discount account shall be subtracted and included in gross income. Section 847(6). Except in the case where a company transfers or distributes its insurance business in an acquisition of assets referred to in section 381(a), if the company is not subject to the tax imposed by section 801 or section 831, for any taxable year, the entire amount in the special loss discount account at the close of the preceding taxable year will be subtracted from the special loss discount account in such preceding taxable year and included in gross income. Id.

In a consolidated return setting, the section 847 deduction is an item calculated separately by each corporation. Section 1.1502-11(a)(1) of the Income Tax Regulations provides that the consolidated taxable income for a consolidated return year shall be determined by taking into account the listed items, including the separate taxable income of each member of the group. Section 1.1502-12 provides that separate taxable income of a member is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations subject to the listed modifications. Because the section 847 deduction is not a listed modification, each corporation calculates its own section 847 deduction. Therefore, each corporation calculates the amount of special estimated tax payments attributable to such deductions.

Even though the section 847 deduction is calculated as a separate item, Parent made the payment on behalf of Sub. This is consistent with section 1.1502-5, which requires that, for regular estimated tax payments purposes, the group is treated as a single corporation. However, these special estimated tax payments are distinguishable from normal estimated tax payments because they are not fungible and cannot be applied to the general tax liability of the group. Because each corporation calculates its own section 847 deduction and Parent (which is not

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a property and casualty insurance company) is not entitled to the benefits of section 847, Parent's payment of the estimated tax was necessarily on behalf of Sub, and therefore Sub should retain credit for the estimated tax paid on its behalf.

Once it is concluded that the special estimated tax payments should be considered separate items, it is consistent with section 1.1502-5 to allow Sub to retain credit for the amounts. Section 1.1502-5(b) provides that if the corporations file estimated tax on a consolidated basis but end up filing separate returns because they fail to elect to file a consolidated return, the parties can allocate the estimated tax payments between the parties if the Commissioner consents. Similarly, in this case, because the special estimated tax payments are in effect made on a separate basis, the entire amount of the special estimated tax payment should be allocated to Sub.¹

Allowing Sub the credit in this case should not present a whip-saw potential. Parent is not an insurance company and therefore is not entitled to the benefits of section 847. If the special account had been considered the Parent group's account, then upon the distribution of Sub, the entire amount of the special loss discount account would have been included into gross income pursuant to section 847(6) because the group would have ceased to conduct insurance business. The special estimated tax payments would have been applied to the additional tax due and the special estimated tax account would have been eliminated.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

Sincerely yours,

/S/

MARK SMITH
Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)

¹ Sub was the only member of Parent's consolidated group that was a property and casualty insurance company. If the group included other members that were subject to section 847 and remained with the group after the spinoff of Sub, the group should retain any amount of the special estimated tax payments attributable to such members.