Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Associate Area Counsel (Salt Lake City)
(Small Business/Self-Employed)

from: Acting Chief, Branch 4
Office of the Associate Chief Counsel
(Financial Institutions & Products)

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subject: Submission Processing under Section 847

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

A =

$B =

$C =

$D =

$E =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 7 =

Year 8 =

Year 9 =

Year 12 =

Year 13 =

Year 17 =

This memorandum is divided into four sections. The first involves Item 1 dealing with insurance company W in a more detailed fact context. Items 2, 3 and 4, relating to insurance companies X, Y and Z involve more general inquiries.

ITEM 1 INSURANCE COMPANY W

ISSUE

Is insurance company W entitled to a restoration of its special estimated tax payments described in § 847(2) as a result of a marginal tax rate increase and certain audit adjustments?

CONCLUSION

Insurance company W is entitled to the restoration of a special estimated tax payment (SETP)(as described in § 847) as a result of the interplay of the § 11 rate increase which occurred in 1993 and § 847(7). The insurance company is also entitled to a restoration of a SETP following certain audit adjustments. The amounts restored to the SETP account will be treated as estimated tax payments (under § 6655) pursuant to the time limits set forth in § 847(2) (that is, in the subsequent corresponding 16th year). Regular estimated tax payments, for example, those estimated tax payments made in Year 1 through Year 17, are subject to a claim for credit or refund under the provisions of § 6511.

FACTS

W is an insurance company subject to tax under subchapter L of the Internal Revenue Code. W discounts its unpaid losses under § 846. W files its federal income tax returns on a calendar year basis. For the tax years Year 2 through Year 8, W claimed deductions pursuant to § 847(1) by making the SETPs described in § 847(2). Further, W established and maintained a special loss discount account (SLDA) under

§ 847(3). For the tax years Year 3 through Year 9, W reported income under § 847(5) as it removed amounts from the SLDA and offset its resulting tax liability by using its SETP account amounts previously paid. The SETP account was correspondingly reduced. In the tax returns for the years Year 3 through Year 9, W reversed the full amount of the SLDA it had previously deducted under § 847(1).

In the memorandum dated A attached to your request for assistance, the following details are set forth.

During Year 2, W elected to file its Federal Income Tax Returns in accordance with the provisions of § 847. From Year 2 through Year 8, W reported in its U.S. Consolidated Federal Income Tax Returns (Forms 1120) deductions allowable under § 847(1) in the amount of $E. The amount was added to W's SLDA. From Year 3 through Year 9, the entire discount reversed and W included $E of income on its consolidated Federal income tax return. (Page 4 of the attached memorandum states that as of the end of Year 12 W's SLDA is zero.)

W contends that, notwithstanding the fact that it paid all of the § 847 tax required to be paid for the applicable periods, W has been double-taxed in the amount of $D, because of the Internal Revenue Service's errors in maintaining the SETP account. Of this amount, $C of the perceived deficiency in the SETP account related to the audit adjustments made to W's tax years Year 7 – Year 12 and $B related to the marginal rate change from 34% to 35% in 1993. As a result of these errors made by the Service in maintaining the SETP account, the account did not contain sufficient funds to satisfy tax liabilities as a result of the reversal of the 847(1) deduction into gross income pursuant to § 847(5). Since the account did not contain sufficient funds, the liability resulting from the reversal of the § 847(1) deduction into gross income was satisfied by the Service applying $D of regular estimated tax payments. W contends that the Service should correct the relevant § 847 tax accounts to reflect the adjustments mandated by § 847. Once the accounts are reconciled $D of regular estimated tax payments will be freed up and available for refund. W further indicated that it is not requesting a refund of the SETP, but instead seeks a refund of the $D of regular estimated taxes that the Service improperly applied to cover a perceived deficiency in its SETP account. The perceived shortfall occurred because the Service did not adjust the SETP, as required by §§ 847(2) and 847(7), respectively, for audit adjustments and the 1993 marginal rate change.

In 1993, § 11 was amended to increase the corporate tax rate from 34% to 35%. W was subject to tax at the regular corporate rates. W did not increase its beginning balance of its SETP account on its 1993 Form 8816 (Special Loss Discount Account and Special Estimated Tax Payments for Insurance Companies).

LAW

For taxable years beginning after December 31, 1987, § 847(1) allows an insurance company that is required to discount unpaid losses (as defined in § 846) a

deduction for the taxable year if special estimated tax payments (SETP) are made as required by § 847(2). This deduction cannot exceed (i) the excess of – (A) the undiscounted, unpaid losses (as defined in § 846(b)) attributable to losses incurred in taxable years beginning after December 31, 1986, over (B) the related discounted, unpaid losses determined under § 846(b) less (ii) any amounts deducted under this paragraph in a preceding tax year.

Section 847(2) provides, in part, that the deduction under § 847(1) shall be allowed only to the extent that such a deduction would result in a tax benefit for the taxable year for which such a deduction is allowed or for any carryback year. In addition, the deduction is allowable only if SETPs are made in an amount equal to the tax benefit attributable to such a deduction on or before the due date (determined without regard to extensions) for filing the return for the taxable year for which the deduction is allowed. If amounts are included in gross income under paragraph (5) … for any taxable year and an additional tax is due for such year (or any other year) as a result of such inclusion, an amount of special estimated tax payments equal to such additional tax shall be applied against such additional tax. If, after such payment is so applied, there is an adjustment reducing the amount of such additional tax, in lieu of any credit or refund for such a reduction, a special estimated tax payment shall be treated as made in an amount equal to the amount otherwise allowable as a credit or refund. To the extent that a special estimated tax payment is not used to offset additional tax due for any of the first 15 taxable years beginning after the year for which the payment was made, such special estimated tax payment shall be treated as an estimated tax payment made under § 6655 for the 16th year after the year for which the payment was made.

Section 847(3) provides that each company that is allowed a deduction under § 847(1) shall, for purposes of this part, establish and maintain a special loss discount account (SLDA).

Section 847(4) provides that there shall be added to the special loss discount account for each taxable year an amount equal to the amount allowed as a deduction for the taxable year under paragraph (1).

Section 847(5) provides that after applying paragraph (4), there shall be subtracted for the taxable year from the special loss discount account and included in gross income:

(A) The excess (if any) of the amount in the special loss discount account with respect to losses incurred in each taxable year over the amount of the excess referred to in paragraph (1) with respect to losses incurred in that year, and

(B) Any amount improperly subtracted from the special loss discount account under subparagraph (A) to the extent the special estimated tax payments were used with respect to such amount.

To the extent that any amount added to the special loss discount account is not subtracted from such account before the 15th year after the year for which the amount was so added, such amount shall be subtracted from such account for such 15th year and included in gross income for such 15th year.

Section 847(10) provides authority for regulations as may be necessary or appropriate to carry out the purposes of the section including regulations providing for the separate application of this section with respect to each accident year. A vintaging methodology would be used similar to the approach of § 846 which implements reserve discounting by accident year.

Section 847(7) provides that in the event of a reduction in any tax rate provided under § 11 for any tax year after the enactment of this section, the Secretary shall prescribe regulations providing for a reduction in the amount of any special estimated tax payments made for years before the effective date of such § 11 rate reductions. Such reduction in the amount of such payments shall reduce the amount of such payments to the amount that they would have been if the special deduction permitted under paragraph (1) had occurred during a year that the lower marginal rate under § 11 applied. Similar rules shall be applied in the event of a marginal rate increase.

Section 6511(a) provides that a claim for credit or refund of an overpayment of any tax imposed in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later.

ANALYSIS

While no regulations have been promulgated under § 847(7), the application of the statute to the 1993 § 11 rate change is clear, especially since during the time frame under consideration W was subject to tax at the regular § 11 corporate tax rates. While the language in § 847(7) focused more heavily on a decrease in the § 11 rates the statute clearly states that its intended application was to § 11 rate increases as well. An illustration of a rate decrease situation would be as follows. If in the first year (after the effective date of the operation of § 847) the highest corporate rate was 34%, an insurance company choosing to claim a $100 deduction under § 847(1) would make a special estimated tax payment of $34. If, however, in the second year (after the effective date of § 847), the highest § 11 corporate rate were to decrease to 28% the insurance company would be considered to have made a special estimated tax payment for the first year of $28. Conversely, if, again, in the first year 1, the highest § 11 rate were 34% in order to claim a deduction an insurance company must make a special estimated tax payment for the first year of $34. However, if in the second year, the highest § 11 corporate tax rate were to increase to 36%, the first year special estimated tax payment for the first year would be deemed to be $36.

In the present illustration, we assume there were pre-1993 special estimated tax payments of $34 for each $100 of § 847(1) deductions taken. However, with the 1993

§ 11 highest corporate rate increase from 34% to 35%, the $34 paid for the special estimated tax payment is now considered to be $35. While the foregoing was intended to be a mere simple illustration, the total amount of the increase in W's example is $B.

Accordingly, each accident year prior to 1993 that has a SETP amount will be increased by 1% under §847(7) to reflect the §11 rate change. The restored SETP accounts are available to offset any increase in tax should amounts in the respective accident year SLDA accounts be included in income. Otherwise, the SETP amount in a particular accident year will be treated as a regular estimated tax payment under § 6511 in the corresponding subsequent 16th year.

With respect to the audit adjustments, for each accident year we are assuming that taxable income that included SLDA amounts was offset by SETP payments prior to the audit adjustments. The audit adjustments would have reduced taxable income in the appropriate accident year thus, eliminating the need to use SETPs to reduce tax. Section 847(2) requires that the SETP account for each accident year be restored to the extent the SETP payments are not needed to offset the tax liability for such accident year as a result of the inclusion of the SLDA amounts. The restored SETP amount for each accident year is not immediately refunded but is treated as an estimated tax payment in the subsequent 16th year. Regular estimated tax payments are subject to a claim for credit or refund under the provisions of § 6511.

ITEM 2 INSURANCE COMPANY X

In this situation the focus is on the fact that some insurance companies had awkward presentations of Federal income tax returns claiming the § 847(1) deduction. For example, on the first page of X's return for calendar Year 13 X showed the full amount of its taxable income without reduction for the § 847(1) deduction. However, the front page of the return contained a reference to a § 847(1) deduction and the return also included a schedule explaining and providing a computation for the § 847 deduction. X made a similar deduction in subsequent years and made the SETPs as it indicated on the schedules attached to those subsequent returns. Service personnel in processing X's return did not pick up on the § 847 deductions and the corresponding SETPs. Instead the Service did not allow the § 847(1) deductions and did not maintain a SETP account, but rather applied all of X's estimated tax payments, along with X's intended SETP to X's tax as calculated by the Service (without regard to § 847). We assume that X has received no tax benefit as a result of having its SETP mischaracterized by the Service and treated as a regular tax payment. In this illustration, the Service Center proposes to comply with X's desire to have the Service establish the SETP and otherwise comply with the actions made by X in its original return filed for Year 13 (and following tax years). Based upon the fact that the Service had notice that X sought tax treatment under § 847(1) and as X acted consistent with that section, we agree.

ITEM 3 INSURANCE COMPANY Y

This fact pattern appears to describe a situation where insurance company Y had never prior to Year 17 claimed a deduction under § 847(1). In its Year 17 Federal income tax return, however, Y for the first time filed a return claiming all the § 847(1) (aggregate) deductions that it did not take in several prior tax years. The facts state that the § 847 claim includes a year prior to the effective date of § 847 (i.e., Year 1) . Y is assumed to have made a SETP with respect to its deduction claims for Year 17 as a condition of taking these § 847(1) deductions for its Year 17 return. We assume that Y's claim would measure the difference between the amount of the undiscounted, unpaid losses (as defined in § 846(b)) and the amount of the related discounted, unpaid losses determined under § 846 for each accident year as of the end of that accident year and then aggregate all of the accident year amounts. By way of example, we assume that for Year 2 the difference between the above two amounts (the undiscounted and the discounted) was $100, Year 3's difference was $110, Year 4's difference was $115 etc. Y's Year 17 return position would be that it is entitled to deduct in Year 17 the sum of $100, $110, $115 etc. If that is, indeed, Y's return position for its Year 17, we disagree.

The facts may be different. Y may be looking at its historical data for Year 2, Year 3 and Year 4 and concluding that if it had claimed a § 847(1) deduction with respect to Year 2, Year 3 and Year 4 (based upon the difference between the amount of the undiscounted, unpaid losses attributable to losses incurred in taxable years beginning after December 31, 1986 and the amount of the related discounted, unpaid losses determined under § 846) it would have been able to deduct $100, $110 and $115, respectively. Y may not be claiming (in Year 17) deductions of such amounts from those prior years. Instead, Y may be looking at its data and finding that from its Year 2, Year 3 and Year 4 accident years it has a difference in amounts (of the undiscounted, unpaid losses attributable to losses incurred in taxable years beginning after December 31, 1986 and the amount of the related discounted, unpaid losses determined under § 846) remaining in Year 17. Y should check its data again to ensure that the amount proposed to be deducted with respect to Year 3 was not already in its Year 2 figure and the amount proposed to be deducted with respect to Year 4 was not a duplication of any amounts proposed to be deducted with respect to its Year 2 or Year 3. Finally, Y may have concluded that it had a difference between the two amounts (the discounted and the undiscounted) that was deductible under § 847(1) with respect to the Year 2, Year 3 and Year 4 accident years of $1, $2, and $3, respectively, and deducted the sum of those amounts under § 847(1) in Year 17. If these are the facts, then we would agree with Y. (See generally Notice 88-100, 1988-2 C.B. 439, which in Section V provides guidance with respect certain long tailed lines, which extend the vintaging of accident years beyond factors applicable for shorter tailed lines).

ITEM 4 INSURANCE COMPANY Z

Insurance company Z was the parent corporation of a number of insurance company subsidiaries all of which were members of Z's group and joined with Z on its consolidated federal income tax return. Z sold the stock of one of its insurance subsidiaries to a new consolidated group. The facts state that each subsidiary has a

computation to arrive at the § 847 deduction as well as the amounts for the SLDA and SETP accounts. Z approached the Service Center personnel and requested a transfer of what it views to be the proper amount in the SLDA to the insurance subsidiary it just sold to an unrelated consolidated group. Z noted that it does not agree with its former subsidiary as to the proper amount that should be transferred to its former insurance subsidiary.

We do not believe that we have enough information to answer this question. We do not know what the Service did with the information it received, that is, what accounts for what taxpayer were set up under § 847, for what years, and in what amounts. We do not know the respective positions of Z and its former insurance subsidiary (e.g., does the difference of views result from a mere calculation error). In addition, we do not know what the position of the Service Center is or what response it made or proposes to make in response to Z's inquiry. We would note that the General Instructions to the current Form 8816 provide guidance. (Each member of a consolidated group claiming a § 847 deduction must file a separate Form 8816. Do not combine several taxpayers on one Form 8816.)

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Please call (202) 622-3970 if you have any further questions.