SELECTED ISSUES AND DEVELOPMENTS IN FEDERAL INCOME TAXES

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This article focuses on certain federal income tax issues that can arise when an insurance company is in receivership and particularly when the insurance company is a member of a consolidated group. It discusses the importance of federal income tax considerations for the receiver (even in a situation where the insurer has significant loss carryforwards) and certain recent developments at the IRS. The article also addresses the considerations in two fairly common scenarios involving the filing (or lack thereof) of the respective federal income tax returns and describes a variety of options and tools to obtain IRS assistance and resolve the insurer's tax situation.

Why Taxes Matter to Receivers

When a receiver is appointed by a court to operate an insurance company that is either in rehabilitation or liquidation, the Internal Revenue Code (IRC) generally imposes an obligation on the receiver personally for the filing of tax returns and potentially for the payment of tax liability. In general, the post-receivership tax liabilities of the company are classified as Class 1 administrative expenses. Tax liabilities incurred during periods prior to the receivership date generally will fall into a liquidating distribution class payable only after policyholder claims have been paid in full. In general, an insurance company in receivership must file a tax return with the IRS (Form 1120-PC if a nonlife insurance company or Form 1120-L if it qualifies as a life insurance company for tax purposes) using the same tax year after receivership as before. Receivers should be aware that the definition of what qualifies as a life insurance company for tax purposes is a complex and tricky quantitative computation and does not depend upon the company's state license classification or which type of Annual Statement it files.

The receiver is required to continue filing tax returns even if the company has large NOLs (net operating losses if a nonlife insurance company) or OLDs (operations loss deductions if a life insurance company) carrying forward into receivership. In addition, an insurer could incur an AMT (alternative minimum tax) in post-receivership years even if existing losses exceed taxable income. This occurs because, in general, only 90% of any pre-NOL taxable income can be offset by the AMT NOL carryforward so that the remaining 10% could cause a 20% AMT to be payable. There is a notable exemption to the AMT for small companies as defined in IRC Section 55(e). Receivers of companies that have previously qualified as life insurance companies for tax purposes also should be aware of the potential for a tax ("Phase III trigger") on any accumulated Policyholder Surplus Account balance. The timing of this tax can be a minefield for unsuspecting receivers, although if a timely election was made for 2005 or 2006 the possibility of a Phase III trigger may have been eliminated.

In general, a three-year statute-of-limitations prevents the IRS from assessing additional tax, such time beginning to run on the date the tax return is filed or the due date of the return, whichever is later. If no tax return has been filed for a particular year, the statute-of-limitations does not begin to run until the return is filed. Further, if there is a 25% or more understatement of gross income in any filed return, a six-year statute-of-limitations applies. Also, if any filed return is later deemed fraudulent by the IRS, the statute-of-limitations never begins to run. Even in cases where the IRS assesses additional tax on a receivership estate, there are significant limitations on the IRS's ability to actually levy or seize receivership assets to satisfy an assessment. The fact that the receivership Court Order prevents any party from obtaining control over its assets is a powerful deterrent to keep the tax collector in check.

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What Is New at the IRS

Since 2010, the IRS's budget has been severely curtailed. Most recently, a freeze on federal hiring was imposed via an Executive Order signed by President Trump on January 23, 2017. In addition, the term of current IRS Commissioner John Koskinen ends on November 12, 2017, and it is not clear whether he will stay given the change in the administration and controversy over his actions as Commissioner. Consequently, there have been many administrative changes at the IRS including longer response times to inquiries, a reduction in the number of audits, additional limitations on issues for which the IRS will consider advance rulings, and significantly higher user fees for private letter ruling requests and pre-filing agreements, and more changes are likely.

One major change that could affect insurance companies is the recent reorganization of the Large Business & International (LB&I) Division of the IRS. LB&I is the principal group handling the examinations for large corporations (those with assets greater than $10 million), so as a practical matter, it is the primary IRS contact for many insurance companies that have outstanding audits. The most recent reorganization announced late in 2015 aligned LB&I's approximately 4,500 employees into four regional practice areas (Western, Central, Eastern, and Northeastern) and five subject matter practice areas (Pass-Through Entities, Enterprise Activities, Cross-border Activities, Withholding and International Individual Compliance, and Treaty and Transfer Pricing Operations). Enterprise Activities is the area generally relevant to insurance companies and the current Director is Kathy J. Robbins. In order to better identify the issues that should be audited, LB&I has instituted a number of changes, including changes to Information Document Requests issued by the IRS which must now be more issue-focused (which focus requires taxpayer input). Also, under a new Campaign Approach, the IRS has identified potential areas of noncompliance, such as the "micro-captive transactions" in the insurance industry, and designed "campaigns" to specifically address them.

Another group relevant to insurers at the IRS is the "Insurance Branch." This is a specific branch in the Financial Institutions and Products Division of the Office of Chief Counsel of the IRS located in Washington, DC. The IRS Office of Chief Counsel has many responsibilities including the issuance of regulations, revenue rulings, revenue procedures, private letter rulings (these rulings are issued to a particular taxpayer and can provide comfort on the tax treatment of particular items such as a type of reorganization) and other general guidance. The Insurance Branch focuses specifically on issues arising under subchapter L for insurance companies and items affecting the taxation of policyholders and can be a good resource to provide answers to technical tax questions in their jurisdiction.

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Common Issues with the Filing of Tax Returns

The most troublesome tax issues for insurance companies in receivership seem to arise when they are or have been members of a consolidated group for federal income tax purposes. In general, the common parent is the sole agent for the group for all matters (except those specifically excepted under the regulations) and, as a result, members of the group have no ability to discuss their outstanding federal tax liability directly with the IRS. Therefore, the lack of common parent cooperation creates all kind of issues addressed in more detail below. On the other hand, if the common parent cooperates, it is possible for a subsidiary (acting through the receiver) to become the agent for the consolidated group so that it can become the voice of the group as far as the IRS is concerned, although this may not always be the desired outcome if there are other members of the consolidated group or for non-tax liability reasons. Alternatively, there are provisions which allow a subsidiary to request that the IRS "break agency" and deal directly with the subsidiary. These options can be helpful when trying to resolve issues described below that can arise within a consolidated group setting.

As a general matter, under IRC Section 1504, a subsidiary is a member if its stock is held by another domestic corporation and that stock represents at least 80% of the voting power and 80% of the value of the outstanding subsidiary stock (although in some cases there might be a waiting period for a new life insurance subsidiary). Once a consolidated return has been filed by the common parent, a consolidated return must continue to be filed (absent the Commissioner's consent to deconsolidate which is rarely given) as long as the 80% affiliation standard is met. Receivership, rehabilitation, or liquidation (assuming there is no transfer of the stock) does not generally result in the subsidiary being deconsolidated from the group. Once a consolidated return is filed, all members of the group share several liability for the tax liability determined on a consolidated basis, even if the member generated no taxable income in the year in question, and without regard to contrary provisions in a tax sharing agreement.

Common parents often fail in their tax filing obligations, causing problems for the receivers of subsidiary insurance companies in the group. Two common failures are as follows: (1) the common parent fails to file a consolidated return even though it is required to file the returns on behalf of the group; and (2) the common parent timely files a consolidated return, but fails to include the receivership subsidiary at all or fails to include complete and accurate information regarding the insurance subsidiary even though the insurer is still listed as a member. A common issue in the second scenario is that the common parent does not share the filed consolidated return with all members of the consolidated group, leaving them in the dark and creating significant uncertainty regarding potential federal tax liability or potential tax refunds allocable to the insurer and further uncertainty regarding whether the receiver's fiduciary obligations with respect to filing returns have been satisfied.

There are many variables that must be considered to determine the best approach in these situations, but some possible approaches are suggested below. In the first scenario, as indicated earlier, if no return has been filed, the statute-of-limitations on assessment has not yet begun to run and, therefore, it is impossible to definitively assess whether there is any federal income tax liability for members of the group, including the receivership subsidiary. In general, in that case, because the common parent is the sole agent, no member has the ability to file the consolidated return. Some companies in this situation have taken a two-fold approach in that they first ask the IRS to "break agency" so that they can act as their own agent and secondly they file either a separate return reflecting only their tax information or a consolidated return on behalf of the group. Either situation likely results in the need to include disclosures in the return (typically on IRS Form 8275 "Disclosure Statement") to explain the reason for the inconsistent filings and any other significant issues. It is important that any separate return include a specific disclosure referenced in the consolidated return regulations so that the return can be treated as starting the statute of limitations on assessment at least with respect to the receivership subsidiary's tax liability. In addition, if a separate return is filed after the due date (with extensions), for example, because the common parent failed to file the return on time, the IRS is likely to automatically assess tax penalties if there is tax shown as due on the return. If the tax is not paid because it is not considered a Class 1 administrative expense or is paid late, for example, the receiver can seek a waiver of some of the penalties by filing Form 843 as described below.

In the second scenario, a consolidated return has been filed, but it either does not list the subsidiary as a member or does not include the subsidiary's complete and accurate tax information, even though the subsidiary is still a member of the group. The tax regulations generally provide that if a consolidated return is required, the group's tax liability must be computed on a consolidated basis, even if separate returns were filed or the income of one member was not included in the consolidated return. The initial challenge here is to try and get a copy of the filed tax return or at least the IRS transcript which covers the year(s) for which the consolidated returns were reportedly filed. This can be very difficult to do without the common parent's assistance. The second challenge is to decide what, if any, actions to take with respect to the filing of tax returns for the year(s) in question. Depending on the content of the filed consolidated return, there might be support for the position that the filed return was in substantial compliance with the requirements for filing and, therefore, there is no requirement to file a separate return reflecting only the subsidiary's tax information. In addition, as a general matter, a taxpayer is under no obligation to file an amended return if it is later determined that the earlier-filed return is incorrect. Alternatively, particularly if a copy of the consolidated return is not available, the receiver may decide to file a separate return to ensure that his/her fiduciary obligations are satisfied. And similar to the separate returns mentioned above, it is important to include a disclosure statement which describes the unique situation for the return filing.

Important IRS Forms

This section provides a list of various forms that can be important to receivers in numerical order.

FORM 56—Notice Concerning Fiduciary Relationship—This Form must be filed with the IRS by the receiver upon being named as the fiduciary for the receivership estate. A "closing" Form 56 should be filed with the IRS when the receivership is closed. IMPORTANT: The Receiver should file Form 56 as soon as appointed. Under IRC Section 6872, failure to file the Form can result in a suspension of the otherwise applicable statute of limitations on assessment for a period of up to two years.

FORM 843—Claim for Refund and Request for Abatement—This Form can be used to request abatement (on the basis of reasonable cause) of late filing and late payment penalties (except for estimated tax penalties) that have been erroneously assessed by the IRS.

FORM 911—Request for Taxpayer Advocate Service Assistance—This Form can be used when the IRS is being recalcitrant about an issue. Hardship cases take priority with the Taxpayer Advocate's office, so the receiver should make a case for hardship based on claims going unpaid while the IRS fiddles around, i.e., is unresponsive.

FORM 982—Reduction of Tax Attributes Due to Discharge of Indebtedness—This Form must be included in the tax return when the receivership has experienced decreases in unpaid claims liabilities (unless from actual payment of claims) that qualify for exclusion from gross income under IRC Section 108 described below.

FORM 2848—Power of Attorney and Declaration of Representative—This Form should be filed with the IRS in order to facilitate dialogue and problem resolution between the IRS and the tax practitioner/advisor. Tax practitioners, designated in a Form 2848, have a special hotline that they can access to speak directly with IRS representatives about outstanding issues. Recently, the IRS has been very particular if the exact name of the taxpayer contained on the Form 2848 differs from the name used in the tax return.

FORM 4506—Request for Copy of Tax Return—This Form has been used with mixed success since the IRS often does not recognize receivers as authorized requesters. Some success has been had with the tax practitioner making this request using powers granted by the receiver under Form 2848.

FORM 4506-T—Request for Transcript of Tax Return—An expedited request is available, but still with mixed success as with Form 4506 above. The transcript contains less information than the actual tax returns, but it is particularly helpful in showing the history of tax payments and any refunds issued to the taxpayer.

FORM 4810 —Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)—This Form should be filed for each tax year immediately after the tax return has been filed. If the IRS grants the request, the usual three-year statute-of-limitations is reduced to 18 months, providing additional protection to the receiver. If there is no immediate time concern and there are potential significant audit issues in the filed return, it may not be beneficial to file the Form

4810 because it could generate an IRS audit of the return. A possible alternative to Form 4810 is a Request for Prompt Determination of Tax Liability pursuant to Rev. Proc. 2006-24, 2006-1 C.B. 943. This procedure can be used to request that the IRS make a choice to either examine already-filed returns, or "accept as filed" the returns already filed. (Technically, this procedure only applies to companies in a title 11 case, but in the past the IRS has extended it to insurers in receivership.) Under this procedure, the IRS has 60 days to decide to either examine the filed returns or issue an "accepted as filed" letter to the receivership. This is different from the Form 4810 procedure described above in that it does not alter the usual three-year statute-of-limitations, but provides, as a practical matter, assurance that the IRS has no issues with the filed returns and would generally not pursue any issues with the filed returns. However, these two procedures are the only avenues for obtaining an IRS "release" of tax returns that have been filed for the receivership. In short, there is no way to achieve an exact "cutoff" of future tax liability that is coincidental with the closing of the receivership. The final tax return for the receivership will still have to be filed after the receivership is closed and before any statute-of-limitations has expired.

FORM 8275—Disclosure Statement—This Form (including a detailed supporting statement) should accompany each year's tax return in order to inform the IRS of the existence of a State Court receivership, especially when the tax return is being filed without being accompanied by an Annual Statement as required by IRS Regulations. The detailed statement should also disclose the basis of accounting used in the tax return as well as the existence of any estimates of material items being used.

FORM 8822—Change of Address—This Form should always be filed at the beginning of each receivership in order to make certain that the receiver is notified of all IRS correspondence being issued, such as assessments and tax adjustments.

Important Code Sections

As a final note, this section highlights some Code sections that are often applicable or arise in connection with receiverships. It by no means covers all potentially applicable Code sections.

IRC SECTION 108—Discharge of Indebtedness Income – Gross income does not include discharge of indebtedness income if the company is either in a title 11 case or insolvent. Insurers can take advantage of the insolvency exclusion in certain cases, although if such income is excluded, IRC Section 108(b) also requires the reduction of certain tax attributes so they might not be available going forward. See Form 982 discussed above.

IRC SECTION 111—Recovery of Tax Benefit Items—"Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter." For this purpose, NOL carryforwards are treated as reducing the amount of tax imposed; however, receivers should be aware of expiring or expired NOL carryforwards that might make this provision useful.

IRC SECTION 831(b) ELECTION--This is a permanent election to be taxed on "Net Investment Income" instead of overall taxable income. This is useful in the case of large litigation and reinsurance recoveries. But, this election is irrevocable without approval of the IRS Commissioner, and likely generates some level of taxable income each tax year. Receiverships can use Early Access Distributions with "claw back" provisions to control the level of assets in the receivership estate earning investment income.

IRC Section 832(c)(5) and Schedule G of FORM 1120-PC— Insurance companies in receiverships can get an ordinary deduction (unlimited) for Capital Losses (which are usually not deductible unless they offset Capital Gains) for "Capital assets sold or exchanged to meet abnormal insurance losses and to pay dividends and similar distributions to policyholders." In other words, if the receiver is forced to sell assets at a loss in order to pay policyholder claims, that loss may be deductible without limitation from ordinary taxable income.

Finally, we are frequently asked whether an insurer in receivership can obtain a release letter from the Federal Government. The answer is yes, but not with respect to federal income taxes. The release letter can be issued by the U.S. Department of Justice. This letter, when received, can assure the receiver that no other department of the Federal Government has an outstanding claim against the receivership. However, this letter will state explicitly that it covers all government departments EXCEPT the department of the Treasury and the Internal Revenue Service. Again, in short, there is no way to achieve an exact "cutoff" of tax liability that is coincidental with the closing of the receivership.

In short, there is no way to achieve an exact "cutoff" of future tax liability that is coincidental with the closing of the receivership.

Conclusion

Different issues can arise depending on the underlying facts and circumstances such as the type of business and whether the insurer is a member of a consolidated group. This article highlights only some of the federal income tax issues that can arise in an insurer receivership. Consequently, dealing with the potential federal tax issues of an insurance company in receivership can be tricky and the possibility of the receiver having personal liability (even if the risk is remote) is an important consideration.