

Office of Chief Counsel
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Memorandum

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to: Gene Bybee
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PSP
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subject:

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.

LEGEND

Company A =

Company B =

year 1 =

year 2 =

year 3 =

year 4 =

year 5 =

year 6 =

year 7 =

date 1 =

X amount =

ISSUE

Company B did not elect to take the I.R.C. § 847(1) deduction, or make the required special estimated tax payments, by the due date, or when it filed its tax returns for tax years 2 through 5. Can Company B file amended tax returns to elect to take the deduction over 10 years after the original tax returns were due, and at the same time recategorize its regular estimated tax payments as special estimated tax payments?

FACTS

Company A is a holding company. Company A through Company B and its subsidiaries writes a full line of property and casualty insurance throughout the United States. Company B has conducted business since year 1.

Company A is a calendar year taxpayer. After the close to the tax years 2 through 5, Company A timely filed income tax returns, (Forms 1120), the following March or September with the Internal Revenue Service (Service).

On or about date 1 Company A filed amended income tax returns, (Forms 1120X), for taxable years 2 through 5. The amended returns (Forms 1120X) state in part as follows:

"Pursuant to IRC Section 847 (1), an additional deduction is allowed in an amount not to exceed the excess of (a) undiscounted unpaid losses incurred beginning after December 31, 1986, over (b) related discounted unpaid losses determined under section 846. To the extent the deduction results in a tax benefit in the taxable year or carryback year, special estimated tax payments must be made in the amount equal to the tax benefit."

"Since section 847 is not intended to change the timing or the amount of taxes paid or refunded in the taxable year, existing taxes paid are simply recategorized as special estimated tax payments." The Company wishes to "recategorize" [X amount] in existing tax dollars to be treated as special estimated tax payments.

The amended income tax returns (Forms 1120X) were timely filed pursuant to agreement of the parties (Forms 872). However, the original income tax returns (Forms 1120) have nothing in them to show that the taxpayer elected to take a deduction under I.R.C. § 847. A Form 8816 was not included with any of the original returns (Forms 1120), and no special estimated tax payments were made as required by I.R.C. § 847(2).

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

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).

computed by 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(1), the Taxpayer must make special estimated tax payments (SETPs) as required by I.R.C. § 847(2). Section 847(2) provides:

(2) Special estimated tax payments.--The deduction under paragraph (1) shall be allowed only to the extent that such deduction would result in a tax benefit for the taxable year for which such deduction is allowed or any carryback year and only to the extent that special estimated tax payments are made in an amount equal to the tax benefit attributable to such 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 a deduction would be allowed but for the fact that special estimated tax payments were not timely made, such deduction shall be allowed to the extent such payments are made within a reasonable time, as determined by the Secretary, if all interest and penalties, computed as if this sentence did not apply, are paid. If amounts are included in gross income under paragraph (5) or (6) 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 any such payment is so applied, there is an adjustment reducing the amount of such additional

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.

tax, in lieu of any credit or refund for such 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 section 6655 for the 16th year after the year for which the payment was made.

The amount of the I.R.C. § 847 deduction in the first year is to be added to a special loss discount account (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 not

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.

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.

I.R.C. § 847 provides that in the case of taxable years beginning after December 31, 1987, an insurance company required to discount unpaid losses (as defined in section 846) - (1) there shall be allowed as a deduction for the taxable year, if special estimated tax payment are made as required by paragraph (2), an amount not to exceed the excess of:

(A) the amount of the undiscounted, unpaid losses (as defined in section 846(b)) attributable to losses incurred in taxable years beginning after December 31, 1986, over

(B) the amount of the related discounted, unpaid losses determined under section 846.

to the extent such amount was not deducted under this paragraph in a preceding taxable year.

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

I.R.C. § 847 (2) provides that the deduction under paragraph (1) shall be allowed only to the extent that such deduction would result in a tax benefit for the taxable year for which such deduction is allowed or any carryback year and only to the extent that special estimated tax payments are made in an amount equal to the tax benefit attributable to such 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.

Sections 847(1) and 847(2) clearly and specifically state that a condition for the allowance of the section 847(1) deduction is the requirement that a special estimated tax payment be made by the due date of the tax return, determined without regard to extensions. The tax returns for the tax years 2 through 5 did not elect to take a deduction under section 847(1), and did not make the special estimated tax payments required by section 847(2) by the due date of the returns. The taxpayer has instead filed amended tax returns for the tax years 2 through 5, over a decade after the due date of the original returns, in which it seeks to claim the section 847(1) deduction for the first time, and in which it requests the Service to recategorize its regular estimated tax payments as special estimated tax payments. While section 847(2) allows for some leniency in the payment of special estimated tax payments by allowing the special estimated tax payments to be made within a reasonable period of time after the due date of the return as determined by the Secretary, a payment over a decade late is not made within a reasonable period of time.⁸ In addition, the Secretary's discretion to allow a payment of special estimate tax payments to be made in a reasonable period of time after the due date of the return only applies when the failure to make timely payment is the only reason to deny the section 847(1) deduction. In this case, the taxpayer did not comply with the other requirements of section 847 because it did not elect to take the section 847(1) deduction on its tax returns for tax years 2 through 5.

To comply with this requirement of section 847, a taxpayer must maintain records of the special loss discount account and the

⁸ We have found no cases interpreting the meaning of a reasonable period of time under I.R.C. § 847(2). However, we note that I.R.C. § 832(e)(2) contains similar language. In AMIC Corp. v. United States, 81-2 USTC ¶ 9754 (E. D. N. C. 1981), the court determined that for purposes of I.R.C. § 832(e)(2) September 15th of the following year, which appears to be the filing date of the return, was a reasonable period of time.

special estimated tax payment, by accident year, for each tax year in which amounts are added to and subtracted from the special loss discount account. I.R.C. §847(5). In addition, the taxpayer must maintain records of the special estimated tax payments made or applied as well as the dual value of the special estimated tax payment under the corporate alternative minimum tax system and the regular tax system. (See Internal Revenue Manual 21.7.4.4.4.11.5.1 for an explanation of what is required by the Code). Company A failed to comply with any of these requirements when it filed its returns for the years 2 through 5, and for more than a decade thereafter.

CONCLUSIONS:

The taxpayer cannot file amended tax returns to elect the to take a deduction under the provisions of I.R.C. § 847(1) over 10 years after the original tax returns were due, and at the same time recategorize its regular estimated tax payments as special estimated tax payments under I.R.C. § 847(2).

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

If you have any questions please contact Joseph F. Long at (860) 290-4090.

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