SOCIETY OF ACTUARIES

Article from:

Taxing Times

September 2006 – Volume 2, No. 2

When Are Guaranty Association Assessments Deductible?

by Peter H. Winslow and Lori J. Jones

Under SSAP No. 35, a liability for guaranty fund assessments must be charged to expense (Taxes, Licenses and Fees) when an insolvency giving rise to a potential assessment has occurred. The amount reported as a liability is the best estimate of the insurer's share of the ultimate loss expected from the insolvency, taking into account the best available information about market share and premiums by state and line of business. Where state law allows a credit for future state premium taxes, the liability is established gross of the probable recovery, with the potential recovery through premium tax credits reported as a separate asset.

In *Principal Life Insurance Company v. United States*, 97 AFTR 2d 2006-1542 (U.S. Ct. Fed. Cl. 2006), the question came up as to whether the insurer was entitled to a current deduction for the portion of the guaranty fund assessments that were potentially available for future premium tax credits. On its tax returns, Principal deducted the guaranty fund assessments on a cash basis, but initially capitalized and amortized the portion available for premium tax credits over the period for which the credits were available. This position conformed to the historic informal position of the Insurance Branch of the IRS National Office. Principal decided to challenge this position and filed claims for refund and a Form 3115 (Application for Change in Accounting Method) to reverse the capitalization treatment. Principal's argument was that the assessments were taxes deductible in full under I.R.C. § 164 for which no capitalization is required.

The Court of Federal Claims rejected Principal's position and held that guaranty association assessments are not taxes for federal income tax purposes. This holding of the court has support in the case law. A tax is "a levy and collection of revenue without relationship to a specific governmental privilege or service." *Cox v. Comm'r*, 41 T.C. 161, 164 (1963). The Court of Federal Claims concluded that the assessment was a regulatory fee as opposed to a tax based on, among other things, the fact that: (i) assessments were imposed by the board of the guaranty association (*i.e.*, not a legislative body or state agency); (ii) the class of those assessed is relatively narrow; and (iii) the assessments are segregated from the revenues of the state and benefit only a very discrete segment of the public (*i.e.*, the guaranty association itself and possibly the insolvent insurer). Although guaranty fund assessments are not taxes, it does not necessarily follow that any portion of the assessments are required to be capitalized. In general, under case law, an amount is required to be capitalized under I.R.C. § 263 if there is a significant future benefit. The fact that a premium tax credit may be available in the future does not necessarily translate to such a benefit. The court did not reach this question, however, apparently because it was not timely raised by the taxpayer.

Regardless of the merits of the decision in *Principal Life*, in effect, it has been overruled by the promulgation of Treas. Reg. § 1.263(a)-4 generally for 2004 and later years. These regulations were intended to eliminate disputes over capitalization by setting forth bright-line criteria for capitalization of amounts paid to acquire or create an intangible asset. Importantly, if the regulations do not specifically require capitalization of a particular expense, and it otherwise qualifies as a trade or business expense, it is currently deductible. T.D. 9107, 2004-1 C.B. 447. Because the regulations do not specifically require capitalization of guaranty fund assessments, beginning with the effective date of the regulations for amounts paid or incurred on or after Dec. 31, 2003, they are deductible despite the holding in the Principal Life case.

Another potential issue not addressed in Principal Life is whether the insurer was correct that guaranty fund assessments are required to be deducted on a cash basis. Non-life insurance companies other than companies subject to I.R.C. § 833 (generally Blue Cross/Blue Shield plans) are entitled to deduct premium-based guaranty fund assessments as premium acquisition expenses on a reserve basis even before they are accrued under the all-events test, and even in some cases before

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP. He may be reached at *pwinslow@scribnerhall.com.*

Lori J. Jones is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP. She may be reached at *ljones@scribnerhall.com.*

there is an insolvency and they are reported on the Annual Statement. Rev. Proc. 2002-46, Sec. 3.01, 2002-2 C.B. 105. This rule does not apply to life insurers.

A deduction prior to payment is available to a life insurer only if it can be successfully argued that the liability is included in reserves for unpaid losses based on the theory that the insurer is acting in the capacity as a reinsurer of insolvent companies, or the liability satisfies both the all-events test and economic performance rules for accrual. It is ironic in light of the parties' arguments in Principal Life that it is IRS auditors who usually argue that guaranty fund assessments are taxes because Treas. Reg. § 1.461-4(g)(6) provides that economic performance occurs for taxes only upon payment. One potential argument to avoid a cash method is that an insurer is providing a service to the state promising to satisfy insolvent insurer's claims so that economic performance is satisfied when these services are performed (i.e., the guaranty is made). See Treas. Reg. § 1.461-4(d)(4). Even if this argument is successful, however, the insurer first has to demonstrate that the amount of its liability is fixed and reasonably susceptible to estimation. Because of the uncertainty of these rules, when the accrual issue comes up on audit, it sometimes is settled at IRS Appeals on the basis of allowing the company a deduction for the amounts actually paid within 8 one-half months after the end of the taxable year (I.R.C. § 461(h)(3)(A)), or the insurer agrees to adopt the cash method as a trade-off for an IRS concession on another issue. Therefore, even with the Principal Life decision, the timing of the deduction of guaranty association assessments for life insurers is still uncertain. ◄

REMINDER • REMINDER • REMINDER • REMINDER

Space Still Available!

Product Tax Seminar

On-site Registration!

Washington, D.C.
September 11-13, 2006
Sponsored by the SOA Taxation Section

Day 1:
Optional "Boot Camp" providing an intense introduction to the basics of product taxation. Choose between Boot Camps focused on:

- Life Insurance
- Annuities & Long-Term Care

Days 2 and 3:
General sessions covering current product tax issues.
Featured products include:

- Life Insurance
- Annuities
- Long-term Care
- Combination Products

The IRS will be invited to participate in this seminar and share their views and perspectives on many of the issues facing our industry.

Register on-line at **www.soa.org**
or on-site at the seminar!

REMINDER • REMINDER • REMINDER • REMINDER