IRS, Tax and Other Federal Issues

Lori J. Jones, Scribner, Hall & Thompson LLP

IAIR Technical Development Series VI

The End of the Road: Issues in Closing Receiverships

October 11-12, 2018

UConn School of Law, Hartford, CT

Importance of Federal Tax Issues to Receivers

- Under 31 U.S.C. section 3713(b), a receiver can be held personally liable if he/she authorizes a distribution which makes the estate insolvent and there is a known or "reasonably should have been known" federal tax liability that is owed at the time of the distribution. IRC Section 6901. Personal liability is limited to the amount of the distribution.
- Receivers are generally obligated to file tax returns with respect to the corporation in receivership. Treas. Reg. section 1.6012-3(b)(4).
- Great resource: NAIC Receivers Handbook on Insurance Insolvencies https://www.naic.org/documents/prod_serv_fin_receivership_rec_bu.pdf.

Priority of Federal Tax Liability

- In general, post-receivership tax liabilities are Class 1 administrative expenses. The date of the accrual of the liability determines whether it is pre- or post-receivership. The IRS takes the view that the date of accrual is generally the last day of the taxpayer's taxable year. I.R.M. 5.9.10.9.
- Under *U.S. Department of Treasury v. Fabe*, 508 U.S. 491 (1993), by reason of the McCarran-Ferguson Act, state law priorities prevail over federal bankruptcy laws which gives taxes a superpriority. As a result, pre-receivership federal tax liabilities (other than administrative expenses) have a lower priority than policyholder claims (but not lower than general creditor or other lower priority claims).

Statute of Limitations on Federal Tax Issues

- The statute of limitations on assessment under IRC Section 6501(a) in general is 3 years after the filing of the tax return.
- To start the statute of limitations on assessment, the return must be filed even if there is no federal tax liability.
- The Internal Revenue Code requires a receiver to file Form 56 (Notice Concerning Fiduciary Relationship). If the Form is not filed, it can result in the suspension of the applicable statute of limitations on assessment for a period of up to 2 years (IRC Section 6872).

Possible Extensions of 3-year Statute of Limitations

- If a return is filed, but is not in substantial compliance with the reporting requirements, the IRS can take the position that the return has not been filed and the statute of limitations on assessment has not begun to run.
- If a return is filed, but omits 25% or more of the corporation’s gross income, the statute of limitations for assessment or a proceeding in court for collection can be extended to 6 years from the filing of the return. IRC Section 6501(e).
- In the case of a false or fraudulent return, the statute of limitations never terminates. IRC Section 6501(c)(1).
- A taxpayer can agree to extend the statute of limitations by filing a Form 872 (Consent to Extend the Time to Assess Tax). The Form must be signed by the taxpayer and the IRS before the statute expires. This is often done when taxpayer’s tax returns are under audit in cooperation with the examiners.

Effect of Disclosures in the Tax Returns on the Statute of Limitations

- If there are tax positions without "substantial authority," it may be beneficial for the taxpayer to disclose the item to the IRS when it files the return, as long as there is a "reasonable basis" for the position. This is done on Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement).
- Disclosure can have the effect of:
  - Eliminating the possibility of potential IRS penalties
  - Preventing application of the 6-year statute with respect to the disclosed item (other than items related to valuation or basis)
  - Potentially triggering an audit by the IRS

Potential Methods to Accelerate 3-year Statute of Limitations That May be Useful to Closing the Estate

- IRC Section 6501(d) provides for "A Request for Prompt Assessment" to be filed by a taxpayer in the process of liquidation. If accepted, the statute of limitations is reduced to 18 months from acceptance. The requests are filed on Form 4810. Note, the IRS has to accept these Forms and they often delay acceptance for a few months so that the statute is somewhat longer than 18 months.
- Rev. Proc. 2006-24, 2006-1 I.R.B. 943, provides "A Request for Prompt Determination" of tax liability where a receiver of a bankrupt taxpayer can ask the IRS to examine filed returns, or accept as filed the return that has already been filed, within 60 days. However, the IRS generally does not allow insurance receivers in state court proceedings to use this approach.

Leins and Levies on Insurance Company Assets during Receivership

- In general, the IRS has 10 years to collect taxes when the assessment has properly been made within the applicable statute of limitations on assessment. If an amount of tax is reported as owed on a filed tax return, the amount reported is considered already assessed. IRC Section 6502.
- The IRS cannot issue a Federal Tax Lien or levy upon assets with respect to assets in the control of the court during receivership. I.R.M. 5.12.2.4.2. See Treas. Reg. section 301.6331-1(a)(3). The 10-year period is tolled during the receivership. IRC Section 6331(i)(5) and IRC Section 6503(b).
- Any portion of claims for taxes allowed in a receivership proceeding which is unpaid must be paid by the taxpayer upon notice and demand from the IRS after the termination of the proceeding. IRC Section 6873.

When to File Final Return

- Under IRC Section 6012, a corporation is no longer a taxpayer after it ceases business and dissolves retaining no assets, whether or not under State law it may thereafter be treated as continuing as a corporation for certain limited purposes connected with winding up its affairs, such as for the purpose of suing and being sued. If a corporation retains valuable contingent receivables, it is still in existence for tax purposes because it has retained assets. Receivership does not terminate a corporation's existence or inclusion in a consolidated group. Treas. Reg. section 1.6012-2(a)(2).

How to File Final Return

- Tax return instructions state that if the corporation is filing a Final Return, the box marked final return on the Form 1120 should be checked. If not checked, the IRS is likely to send out letters asking the whereabouts of the later returns. Disclosures can help ensure that there is no 6-year statute in that case.
- If there is tax owed on the Final Return, it should be treated as an administrative expense.
- Form 4810 should be filed immediately after the Final Return to accelerate the statute of limitations (unless there are significant tax issues in the Final Return).

Primary Recommendation re Final Return

- Try to minimize, if not eliminate, the federal tax issues that could arise on the Final Return.
- If there are outstanding tax issues, try to address them in returns filed several years prior to filing the final tax return.
- Section 831(b) is an election to be taxed on net investment income (so that changes in reserves do not result in income or deductions), but it should be carefully considered as it is permanent and can increase tax liability in certain cases.
- This is often easier said than done.

Use of Net Operating Losses to Absorb Taxable Income

Use of post-2017 net operating losses (NOLs) are limited to 80% of taxable income unless the corporation is a property/casualty insurance company in its final year and the offset is against property/casualty income. Pre-2018 NOLs are not subject to the 80% limitation.

Sometimes NOLs are subject to limitations because of changes in ownership at the insurer level or above the insurer level, such as in a consolidated return. IRC Section 382.

Minimum Tax Credits

The corporate AMT was repealed effective January 1, 2018, and refunds of minimum tax credits from prior years may be available.

Special Consolidated Return Issues

- If more than 80% of the stock of an insurer is owned by another corporation, it may be a member of a consolidated group. In that case, the insurer cannot file its own return. Instead, the common parent of the group must file the return.
- What if the common parent fails to file consolidated return?
  - Consider asking the IRS to "break agency" so that insurance receiver can deal directly with IRS and potentially file a separate return.
  - If a separate return is filed, it is important to include the disclosure language in Treas. Reg. section 1.1502-75(g)(2) to make sure it is treated as a return for purposes of the statute of limitations on assessment.
- What if a common parent files the return but does not include the insurance company? It is possible that nothing more needs to be done and that the expiration of the statute of limitations on that return will protect the subsidiary as long as the return is in substantial compliance with reporting rules.

Special Consolidated Return Issues Con’t

- As a member of a consolidated group, an insurer is severally liable for all of the consolidated tax liability (including for other members) for years in which it is a member. Treas. Reg. section 1.1502-6.
- This may make it difficult to accurately determine the potential amount of outstanding federal tax liability.
- One option is to effect a deconsolidation so that the insurer can file separate returns for the last years of the estate and better assess the potential outstanding taxes owed.
- Consolidated return filings can also raise question as to the ownership of a net operating loss, interpretation of a Tax Sharing Agreement, and timing on worthless stock deductions.

Elimination of Liabilities on Final Return

- One likely issue in the Final Return is whether the discharge of the remaining unpaid insurance liabilities is taxable to the insurer. The elimination of debt (generally measured by tax reserves) should qualify for the IRC Section 108 exclusion if the company is insolvent.
- IRC Section 108 provides that gross income does not include discharge of indebtedness income to the extent that a taxpayer is insolvent immediately before the discharge. If it applies, the insurer is required to reduce any tax attributes in an equal amount.
- Often, the tax reserves are eliminated in the Final Return and then offset by an accrued claim with the unpaid portion discharged by the Final Court Order.

Other Methods to Minimize Tax Issues on Final Return

- File a Private Letter Ruling Request
  - The cost is $28,300. If granted, the IRS will rule on the specific tax issue presented by the corporation.
- File a request for a Pre-Filing Agreement
  - The cost is $174,000 (for requests received after 2/1/18). The IRS is asked to resolve an issue before the tax return is filed. Generally, these agreements are limited to factual situations of well-settled law. Rev. Proc. 2016-30, 2016-21 I.R.B. 981.

Closing the Estate/Final Tax Returns

- Determine amount that might be needed to pay federal income tax liability, including interest and penalties, and hold it in a reserve.
- Transfer reserve assets outside the corporation. Potentially prepay expenses relating to filing of Final Return and other administrative expenses.
- Distribute remaining assets to policyholders or creditors (or to another entity).
- Dissolve corporation for state law purposes.
- File Final Return.

Option 1 - Transfer of Remaining Assets to a Grantor Trust

- The assets in a grantor trust are owned by the grantor(s) if the grantor(s) has certain rights. All income or deductions flow through to the grantor(s). Sections 671-679. (No tax return is generally filed by a grantor trust, but there are reporting obligations to the grantors.)
- For example, all of the remaining assets of the insolvent insurer, including any reserve for taxes, could be transferred to a grantor trust. For tax purposes, the distribution of assets is deemed to occur first to the grantor(s) and then the grantor(s) is deemed to contribute the assets to the Trust.
- Oversight in the Trust can be maintained by the receiver as the Trustee until the liabilities are known or eliminated.
- As long as the Trust does not engage in a trade or business, this transfer should terminate the existence of the corporation for federal income tax purposes.

Potential Uses of Grantor Trust

- For example, we used a grantor trust in the liquidation of a mutual company where all remaining assets were being distributed to policyholders as owners.
  - This could result in a taxable distribution to the policyholders if the amount of assets allocable to each one was known at the time of the distribution. In our case, the amount of the distribution to policyholders was zero because the assets were offset by potential liabilities, including tax liabilities.
- We also used a grantor trust where all residual assets were being distributed to the shareholder.
  - Because the corporation was solvent, there was no tax liability to the shareholder or the dissolving corporation when the corporation was dissolved and all assets transferred to the trust. IRC Section 332/337. The receiver retained control of the Trust until certain there were no remaining federal tax liabilities.

Option 2 - Transfer of Assets to a Liquidating Trust

- A liquidating trust is a separate taxable entity and files a Form 1041 (U.S. Income Tax Return for Estates and Trusts) if, for any taxable year, it has taxable income or gross income of $600 or more.
- All of the assets of the corporation that cannot be distributed could be transferred to the liquidating trust and the corporation dissolved.
- Key is that, if the assets are transferred to another entity like a trust the trust cannot operate a trade or business or the corporation will be treated as continuing.
- This Form can be helpful if there are illiquid assets or if distributions are likely to be escheated pursuant to unclaimed property laws.

Option 3 - Transfer of Assets to an Escrow Account Held by Insurance Department

- Remaining assets could be transferred to a regular bank or escrow account owned by the insurance department and the insolvent insurer liquidated.
- Holding the assets in a non-interest bearing account would eliminate the possibility that the account generated income or there was any tax liability during the holding period.
- This approach is likely only viable when the amount retained is relatively small.

Any questions?