



FINANCIAL SERVICES

- Insurance Tax Bulletin

PRICEWATERHOUSECOOPERS 

Tax Court Rules on Deductibility of Conversion Payments

October 31, 2008

Alert Number: 08-100

In TC Memo 2008-236, the Tax Court looked to the "origin of claim" doctrine in determining the deductibility of "conversion" payments made to resolve state lawsuits arising after conversion of three insurance companies from non-stock, nonprofit organizations to stock, for-profit organizations located in Connecticut, Kentucky, and Ohio, as well as in determining the deductibility of legal and professional expenses incurred to defend against these lawsuits. After its analysis of the "origin of claim" doctrine, the Tax Court held that the settlement payments and litigation and professional fees are capital expenditures, and therefore, not deductible under section 162(a).

Under the "origin of claim" doctrine, the substance of the underlying claim or the transaction out of which the expenditure arose governs whether the item is a deductible expense under section 162(a) or a capital expenditure. This determination is made irrespective of the intent of the payor in making the payment. The "origin of claim" test does not involve a "mechanical search for the first in the chain of events," but requires consideration of the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the amounts claimed as deductions were expended, and all other facts relating to the litigation.

- **Character of the Claim-Settlement Payments:** In its analysis, the Tax Court stated that, the predominant claim in each of the lawsuits was the "cy-pres" doctrine. Under the "cy-pres doctrine", if property has been dedicated in trust for a particular charitable purpose, and that purpose is not being carried out, a state attorney general is authorized to commence a cy-pres proceeding to carry out the charitable purpose.

Each attorney general insisted that the state Blue Cross Blue Shield ("BCBS") entity had a charitable purpose, had received beneficial treatment under state and federal law because of that purpose, and were therefore impressed with a charitable trust. They contended the entities' charitable purposes were no longer being met and that the charitable assets that had accumulated should be taken from the entity's control and redirected to carry out the same charitable purpose.

The Tax Court stated that, since the attorneys general brought suit to recuperate equitable title to assets they thought were impressed with charitable trusts, the "origin of claim" was in fact over title to the assets in all three lawsuits. The Judge further noted that, "costs incurred in defending against claims challenging a taxpayer's ownership of assets are also capital expenditures.

PwC Observes: The Tax Court illustrated its ability to invoke the origin of the claim doctrine and look past the mere intention of a taxpayer in determining the treatment of payments. This case is in complete agreement with the IRS' recently stated view that conversion payments should not be deductible payments.

For additional information please call Anthony DiGilio at (202) 414-1702 or contact your local insurance tax professional. Please visit us at: <http://www.pwc.com/us/insurance/tax>

© 2008 PricewaterhouseCoopers LLP All Rights Reserved. PricewaterhouseCoopers refers to the U.S. firm of PricewaterhouseCoopers and other members of the worldwide PricewaterhouseCoopers organization.

This document is provided by PricewaterhouseCoopers LLP for general guidance only, and does not constitute the provision of legal advice, accounting services, investment advice, written tax advice under Circular 230 or professional advice of any kind. The information provided herein should not be used as a substitute for consultation with professional tax, accounting, legal, or other competent advisers. Before making any decision or taking any action, you should consult with a professional adviser who has been provided with all pertinent facts relevant to your particular situation. The information is provided 'as is' with no assurance or guarantee of completeness, accuracy, or timeliness of the information, and without warranty of any kind, express or implied, including but not limited to warranties or performance, merchantability, and fitness for a particular purpose.