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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR PHOEBE L. NEARING
DISTRICT COUNSEL, MICHIGAN DISTRICT
CC:NER:MIC:DET

FROM: Lon B. Smith
Acting Associate Chief Counsel (Financial Institutions and
Products) CC:FIP

SUBJECT: Section 847 – Special Estimated Tax Payments – Sale Of
Electing Company's Stock When Section 338(h)(10) Election
In Effect

This Field Service Advice responds to your memorandum dated May 31, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Taxpayer =

Sub =

Year 1 =

Year 2 =

Year 3 =

Year A =

Date 1 =

ISSUES

1. What effect does the sale of Sub's stock by Taxpayer outside Taxpayer's affiliated group have on the special loss discount account ("SLDA") maintained by Sub under I.R.C. § 847(3), if a § 338(h)(10) election is in effect for the sale of Sub's stock?

2. What effect does the sale of Sub's stock by Taxpayer outside of Taxpayer's affiliated group have on special estimated tax payments ("SETPs") previously made by Sub, if a § 338(h)(10) election is in effect for the sale of Sub's stock?

CONCLUSIONS

1. Under § 847(6)(A) of the Code, the entire amount remaining in Sub's SLDA account at the time its stock was sold by Taxpayer outside Taxpayer's affiliated group is included in Sub's gross income on its final return as a member of Taxpayer's affiliated group.

2. Under § 847(2), an amount of SETPs equal to the additional tax generated as a result of the sale of Sub's stock outside Taxpayer's affiliated group will be applied as a credit against such additional tax. As provided in § 847(6)(B),

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any SETPs remaining after the application of SETPs against the additional tax generated by the income inclusion under § 847(6)(A) will be voided.

FACTS

Taxpayer is a diversified holding company. Sub is a property and casualty insurance company taxable under § 831(a) of the Code. Taxpayer files a consolidated return on a calendar year basis.

In Year 1, the stock of Sub was purchased by Taxpayer, and Sub became a member of the Taxpayer's affiliated group. On Date 1, Year A, Taxpayer sold Sub's stock outside Taxpayer's affiliated group. A § 338(h)(10) election was jointly made for the sale of Sub's stock by Taxpayer and the purchaser of the stock.

From Year 2 to Year 3 (the calendar year prior to Taxpayer's sale of Sub's stock), Sub elected to take the additional deductions provided by § 847 of the Code, and accordingly made SETPs. As required by § 847(3)-(5), Sub maintained an SLDA account. In computing its separate taxable income for its last year before leaving Taxpayer's affiliated group, Sub brought the remaining balance of its SLDA account into gross income. Taxpayer then claimed the entire remaining balance of its SETPs (according to Sub's and Taxpayer's records) as a prepayment credit. The service center's records indicated that Sub's remaining balance of SETPs was a lower amount than Taxpayer claimed. The service center refunded Taxpayer the lower amount.¹

LAW AND ANALYSIS

Section 832(a) provides, in the case of an insurance company subject to the tax imposed by § 831, that the term "taxable income" means the gross income as defined in § 832(b)(1) less the deductions allowed by § 832(c).

Section 832(b)(1)(A) of the Code defines the term "gross income" to include the combined gross amount earned during the taxable year from investment income and from underwriting income as provided in § 832(b), computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners.

¹ Note that your memorandum to us states that, upon receiving this Field Service Advice, the revenue agent assigned to this case will work with the service center to reconcile the difference between its records and Taxpayer's with regard to the remaining balance in Sub's SETP account.

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Section 832(b)(3) of the Code provides that the term "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

Section 832(b)(5) of the Code provides that the determination of "losses incurred" includes the net change during the taxable year of "discounted unpaid losses," as defined in § 846.

Section 847(1) of the Code allows an insurance company required to discount unpaid losses (as defined in § 846) to deduct an amount, not to exceed the excess of the undiscounted unpaid losses (as defined in § 846(b)) over the amount of the related discounted unpaid losses (determined under § 846), to the extent not deducted in a prior taxable year. As provided in § 847(2), this deduction is allowed only to the extent it results in a tax benefit in the current taxable year or in any carryback year, and only to the extent that SETPs are made in an amount equal to the tax benefit attributable to the deduction.

Section 847(3) requires each insurance company that is allowed a deduction under § 847(1) to establish and maintain a SLDA. Under § 847(4), an amount equal to the amount allowed as a deduction for the taxable year under § 847(1) is added to the insurance company's SLDA. Under § 847(5), amounts are subtracted from the SLDA and included in gross income as losses are paid and the related discount declines.

Section 847(6)(A) provides that, if an insurance company liquidates or otherwise terminates its insurance business and does not transfer or distribute its insurance business in an acquisition of assets referred to in § 381(a), the entire amount remaining in the company's SLDA will be subtracted and included in gross income. Section 847(6)(A) further provides that, except in the case where a company transfers or distributes its insurance business in an acquisition of assets referred to in § 381(a), if the company is not subject to the tax imposed by § 801 or § 831 for any taxable year, the entire amount in the SLDA at the close of the preceding taxable year will be subtracted from the SLDA in such preceding taxable year and included in gross income.

Section 847(2) provides that, if amounts are included in gross income under § 847(5) or § 847(6) for any taxable year and an additional tax is due for such year (or any other year) as a result of the inclusion, an amount of SETPs equal to the additional tax will be applied against such additional tax.

Section 847(6)(B) provides that, in any case to which § 847(6)(A) applies, any SETPs remaining after the credit attributable to the income inclusion under § 846(6)(A) will be voided.

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Section 381(a) refers to the acquisition of assets of a corporation by another corporation –

(1) in a distribution to such other corporation to which § 332 (relating to the liquidation of subsidiaries) applies; or

(2) in a transfer to which § 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in § 368(a)(1)(A), (C), (D), (F), or (G).

Section 338 of the Code allows certain elections to be made in the case of any qualified stock purchase (as defined in § 338(d)(3)). Upon the making of a § 338 election, the corporation ("Target") whose stock is being sold is considered to be two separate corporations, "Old Target" (which refers to Target for periods ending on or before the close of Target's acquisition date (as defined in § 338(h)(2))) and "New Target" (which refers to Target for subsequent periods). Old Target is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the assumption of, or taking subject to, liabilities. New Target is treated as acquiring all of its assets from an unrelated person in exchange for consideration that includes the assumption of, or taking subject to, liabilities. Together, Old Target's transfer and New Target's acquisition of Target's assets are referred to as the deemed asset sale. If a § 338(h)(10) election is made, Old Target is deemed to liquidate after the deemed asset sale, while it is still a member of the selling consolidated group or owned by the selling affiliate. Other rules of law then apply to determine the tax consequences to the parties as if the parties had actually engaged in the transactions deemed to occur. See § 338(a)&(h)(10); § 1.338(h)(10)-1(a)&(e) of the Income Tax Regulations.

Applying this analysis to the facts of the present case, Sub, as Old Sub and New Sub, is treated as first engaging in a deemed asset sale. Upon the transfer of its assets to New Sub, Old Sub's insurance business terminates. Old Sub is then treated as making a liquidating distribution under § 332 to Taxpayer. Because Old Sub is deemed to hold the proceeds of the asset sale, not the assets of the insurance business, at the time of the liquidation, Old Sub is deemed to have transferred or distributed the proceeds of the asset sale, not its former assets (including the insurance business), to Taxpayer in the § 332 liquidation.

Further, Old Sub's insurance business is not deemed to be acquired in a distribution or transfer to which § 361 applies, since gain was recognized on New Target's deemed acquisition of Old Target's assets from an unrelated person.

As indicated above, § 847 applies here as if the parties had actually engaged in the transactions deemed to occur as a result of the § 338(h)(10) election. Thus, for purposes of § 847, Sub (i.e., Old Sub) is treated as liquidating as a result of the

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sale of its stock and the § 338(h)(10) election. Thus, the last taxable year of Sub (as Old Sub) is treated as being the taxable year beginning on January 1, Year A, and ending on Date 1, Year A. See § 443 of the Code and § 1.443-1(a)(2) of the regulations. Moreover, as set forth above, Sub's insurance business is not transferred or distributed in an acquisition of assets referred to in § 381(a). Therefore, under § 847(6)(A), the entire amount remaining in Sub's SLDA account on Date 1, Year A, is subtracted from Sub's SLDA account and included in its gross income for its short taxable year beginning on January 1, Year A, and ending on Date 1, Year A (Sub's last return as a member of Taxpayer's affiliated group). This amount will be reflected in Taxpayer's consolidated return for Year A. See §§ 1.1502-2 and 1.1502-11 of the regulations.

Under § 847(2), an amount of SETPs equal to the additional tax generated by the income inclusion under §847(6)(A) will be applied as a credit against such additional tax. Under § 847(6)(B), any SETPs remaining after the SETPs are so applied will be voided.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The hazards presented by this Field Service Advice are minimal since this Field Service Advice consists of straightforward applications of the Code and the regulations.

Please call, (202) 622-3970, if you have any further questions.

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