INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 02, 2008

Number: **200914022**
Release Date: 4/3/2009

Third Party Communication: None
Date of Communication: Not Applicable

Index (UIL) No.: 332.08-00, 381.00-00, 381.21-00
CASE-MIS No.: TAM-133939-08

Acting Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Parent =

Insurance Subsidiary =

Operating Subsidiary M =

Consultant N =

State A =

State B =

Date A	=
Foreign Country C	=
Year 1	=
Year 5	=
Active Business 1	=
Active Business 2	=
x	=
y	=

ISSUE:

Whether discounted unpaid losses within the meaning of § 832(b)(5)(A)(ii) of the Internal Revenue Code in the hands of an insurance company which is the distributing corporation in a complete liquidation of that subsidiary into its non-insurance company parent under § 332 is an attribute under § 381 which may be transferred to the distributee parent corporation?

FACTS:

Parent is a publicly-traded domestic holding company headquartered in State A. Parent is the common parent of an affiliated group of corporations that join in filing a consolidated federal income tax return. Parent primarily conducts its businesses, Active Business 1 and Active Business 2, in the United States and abroad, through its direct and indirect subsidiaries.

Parent also formed Insurance Subsidiary. Insurance Subsidiary was organized in Year 1 in Foreign Country C and in Year 5 was redomesticated to State B. Insurance Subsidiary was included in Parent's consolidated federal income tax return. Insurance Subsidiary was classified as a corporation for federal income tax purposes in accordance with § 301.7701-2(b).

During its existence, Insurance Subsidiary provided coverage for the deductibles and self insured retentions under Parent's casualty insurance programs such as workers' compensation, auto liability, product liability, and general liability. In sum, Insurance Subsidiary issued guaranteed cost insurance policies to group members conducting

business in the Active Business 1 and Active Business 2 areas. Parent and its operating subsidiaries retained third-party insurance, and Insurance Subsidiary bundled the deductibles for the third-party insurance on Parent and its operating subsidiaries.[1] Insurance Subsidiary provided coverage only to Parent and its operating subsidiaries, not to third parties.

Insurance Subsidiary calculated its taxable income in accordance with Part II of Subchapter L of the Internal Revenue Code. At the end of its fiscal year, Date A, Insurance Subsidiary had cumulative loss reserves for federal income tax purposes, under its current method of insurance accounting, equaling Amount $x. In considering this request for technical advice the National Office has not examined Insurance Subsidiary's calculations or method of accounting with respect to Insurance Subsidiary's loss reserves. However, for purposes of this technical advice memorandum we assume that the unpaid loss reserve calculations were correct. Insurance Subsidiary calculated its insurance loss reserves in accordance with § 832(b)(5)(A), which is reflected on Parent's consolidated year-end tax return for Date A, on Form 1120-PC.

For valid business purposes, Parent terminated Insurance Subsidiary as an insurance company on Date A. The termination of Insurance Subsidiary is reflected in the Plan and Merger Agreement (Agreement) between Insurance Subsidiary and Parent, and the Agreement stated that the merger was effective at 11:59 P.M. on Date A. All existing insurance contracts underwritten by Insurance Subsidiary were cancelled, as of Date A, by Parent, which is reflected in letters of correspondence sent from Parent to Insurance Subsidiary. Policies that had not run their full term when the insured cancelled the policies resulted in premium refunds. Further, the Agreement stated that at the time of the merger, Insurance Subsidiary was to surrender its various licenses and certificates issued by the Insurance Department of State B that had previously allowed and provided Insurance Subsidiary the ability to underwrite various forms of insurance and to issue such insurance policies. In addition, Parent submitted a letter to the examination team which was written by Consultant N regarding Insurance Subsidiary. This letter stated that Insurance Subsidiary's balance sheet as of the close of Date A contained no liabilities or assets at that time. Correspondence also indicated that earlier on Date A, a substantial amount of Insurance Subsidiary's unpaid losses, approximating y percent (of its total unpaid losses) were incurred but not reported losses (IBNR).

As a result of the termination of Insurance Subsidiary, Insurance Subsidiary merged into its sole shareholder, Parent, on Date A, in a transaction that qualified as a statutory merger under the laws of State A and State B and as a § 332 complete liquidation. All of the outstanding common stock of Insurance Subsidiary was cancelled automatically without any action by the holder. At, and after the merger, Parent became responsible for all liabilities and obligations of Insurance Subsidiary, and any claim existing or pending by or against either entity may have been prosecuted as if the merger had not

[1] Insurance Subsidiary also provided excess property and crime coverage to entities within Parent's group.

taken place. Neither the rights of creditors, nor any liens by the creditors upon the property of Insurance Subsidiary or Parent were impaired by the merger.
Parent is not an insurance company and did not become one when Insurance Subsidiary was liquidated into it. Parent has not presented any information to the Service's examination team showing that Parent has any authority under State B law, or any other state law, to engage in the business of underwriting insurance policies or to provide insurance coverage to any entity. Nevertheless, when Insurance Subsidiary ceased to exist, Parent transferred over to its own books and records the reserves which Insurance Subsidiary had maintained. Parent intends to use the method of accounting for these reserves which would be available to Insurance Subsidiary had Insurance Subsidiary continued to do business as an insurance company. The Service's examination team has challenged Parent's adoption of Insurance Subsidiary's method of accounting for these previously deducted reserves.

Insurance Subsidiary's position is that in the complete liquidation of a subsidiary under § 332, corporate items or attributes including insurance items carryover to Parent as the distributee corporation. See § 381(c)(4).

The position urged by the examiner is that since Parent is prohibited from using the reserve method of accounting under § 832(b)(5), it may not use reserve accounting upon the liquidation of Insurance Subsidiary. Further, the examiner urges that § 381(c)(22) overrides any argument that the taxpayers may have under § 381(c)(4) because § 381(c)(22) as the more specific provision overrides § 381(c)(4).

LAW:

Section 332(a) provides that no gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation. Section 332(b)(1) and (2) provide in part that a distribution shall be considered in complete liquidation if (1) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) meeting the requirements of § 1504(a)(2) and if (2) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year.

Section 381(a)(1) provides that in the case of the acquisition of assets of a corporation by another corporation in a distribution to which § 332 (relating to liquidations of subsidiaries) applies, the acquiring corporation shall succeed to and take into account, as of the close of the day distribution, various tax attributes of the distributing corporation as described in § 381(c), subject to various conditions and limitations specified in § 381(b) and (c).

Section 381(c)(4) provides that the acquiring corporation shall use the method of accounting used by the distributor corporation on the date of distribution unless different methods were used by several distributor corporations or by a distributor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of computing taxable income adopted pursuant to regulations prescribed by the Secretary.

Section 381(c)(22) provides, in effect, that if the acquiring corporation is an insurance company taxable under subchapter L, it must take into account those items of the distributor corporation required to be taken into account for purposes of subchapter L (to the extent proper to carry out the purposes of § 381(a) and subchapter L and under such regulations as may be prescribed by the Secretary).

Section 1.381(c)(22)-1 of the Income Tax Regulations provides in part that if in a taxable year beginning after December 31, 1957, a distributor corporation which is an insurance company is acquired by a corporation which is an insurance company in a transaction to which § 381(a) applies, § 381(c)(22) provides that the acquiring corporation shall take into account the appropriate items which the distributor was required to take into account for purposes of Part I, subchapter L, Chapter 1 of the Internal Revenue Code.

Section 1.381(c)(22)-1(b) of the regulations provides that if a transaction meets the requirements of § 381(a) of this section, the acquiring corporation shall except as otherwise provided, take into account as of the close of the date of distribution the following items of the distributor corporation. Section 1.381(c)(22)-1(b)(7)(iv) of the regulations describes such a limitation. Section 1.381(c)(22)-1(b)(7)(iv) provides, in part, that if the acquiring corporation is a mutual life insurance company, the dollar balances in the shareholders surplus account, policyholders surplus account, and other accounts shall not be taken into account by such acquiring corporation and the distributor corporation shall be subject to the provisions of former § 815(d)(2)(A) as of the close of the date of distribution.

Former § 815(d)(2)(A) provides, in part, that except as provided in § 381(c)(22) (relating to carryovers in certain corporate adjustments), if –

(i) for any taxable year in which the taxpayer is not an insurance company, or

(ii) for any two successive taxable years the taxpayer is not a life insurance company,

then the amount taken into account under former § 802(b)(3)[2] for the last preceding year for which it was a life insurance company shall be increased (after the application

[2] Former § 802(b)(3) has been replaced by § 815(a) of the current Code. See also §§ 815(d), (e), (f) and (g) as well as the cross reference to § 815 in § 801(c).

of subparagraph (B)) by the amount remaining in the policyholders surplus account at the close of such preceding taxable year.

Former § 815(d)(2)(B) provides that if for any taxable year, the taxpayer is an insurance company but not a life insurance company, then any distribution to shareholders during such taxable year shall be treated as made on the last day of the last preceding year for which the taxpayer was a life insurance company.

Former § 824(a)(1) prior to the Tax Reform Act of 1986 (dealing with adjustments to provide protection against losses) provided that in determining the statutory underwriting income or loss for any taxable year there shall be allowed as a deduction the sum of – (A) an amount equal to 1 percent of the losses incurred during the taxable year (as determined under § 832(b)(5)), plus (B) an amount equal to 25 percent of the underwriting gain for the taxable year, plus (C) if the concentrated windstorm, etc., premium percentage for the taxable year exceeds 40 percent, an amount determined by applying so much of such percentage as exceeds 40 percent to the underwriting gain for the taxable year.

For purposes of this paragraph, the term “underwriting gain” means statutory underwriting income, computed without having any deduction under this subsection.

Section 824(c)(4) provides that if the taxpayer is not subject to tax under § 821 (dealing with the tax on mutual insurance companies to which Part II applies) for any taxable year, the entire amount in the account at the close of the preceding taxable year shall be subtracted from the account in such preceding taxable year.

Section 807(f)(1)(A) provides that for purposes of Part I of subchapter L,[3] if the basis for determining any item referred to in § 807(c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year, then so much of the difference between –

(i) the amount of the item at the close of the taxable year, computed on the new basis, and

(ii) the amount of the item at the close of the taxable year, computed on the old basis,

[3] It is noted that Rev. Rul. 65-240, 1965-2 C.B. 236, which provides that where an insurance company, subject to tax imposed under § 831, issues life insurance as well as casualty insurance contracts, any increase or decrease in its life insurance reserves due to a change in basis of computing such reserves shall be taken into account in accordance with the same federal income tax rules (the predecessor to § 807(f)) in respect of reserve strengthening or weakening as are provided for in determining gain or loss from operations of life insurance companies.

as is attributable to contracts issued before the taxable year shall be taken into account under the method provided in subparagraph (B).

Section 807(f)(1)(B) states that the method provided in this paragraph is as follows:
(i) if the amount determined under subparagraph (A)(i) exceeds the amount determined under subparagraph (A)(ii), 1/10 of such excess shall be taken into account, for each of the 10 succeeding taxable years, under § 805(a)(2); or

(ii) if the amount determined under subparagraph (A)(ii) exceeds the amount determined under subparagraph (A)(i), 1/10 of such excess shall be included in gross income, for each of the 10 succeeding taxable years, under § 803(a)(2).

Section 807(f)(2) provides that except as provided in § 381(c)(22) (relating to carryovers in certain corporate readjustments), if for any taxable year the taxpayer is not a life insurance company, the balance of any adjustments under this subsection shall be taken into account for the preceding taxable year.

In United States v. General Dynamics Corp., 481 U.S. 239 (1987), an accrual method taxpayer self-insured its liability for its employee medical care plan. The taxpayer established a reserve at the end of the year for its obligation to reimburse employees for medical care already received by the employees from third parties, but for which reimbursement claims had not yet been filed. The taxpayer deducted the amount of its estimated liability in this reserve account at the end of the tax year as an accrued expense.

The Supreme Court held that the last event necessary to fix liability was submission of a claim form by an employee, not the receipt of medical care, and thus, the first prong of the all events test was not met because the last event necessary to fix that liability had not occurred by the end of that year. The Court concluded that some individuals might not file a claim for reimbursement because of oversight, procrastination, confusion over the coverage provided, or fear of disclosure to the employer of the extent or nature of the services received. Thus, the Court reasoned that the filing of a claim was not a mere technicality, but a condition precedent to liability on the part of the taxpayer.

The Supreme Court in supporting its conclusion that the claims estimated by General Dynamics were not intended to fall within the “all events” test stated that its conclusion was further demonstrated by the fact that the Internal Revenue Code specifically permits insurance companies to deduct additions to reserves for such incurred but not reported claims” (IBNRs). If the “all events” test permitted the deduction of an estimated reserve representing claims that were actuarially but not yet reported, Congress would not have needed to maintain an explicit provision that insurance companies could deduct such reserves.[4]

[4] The Court pointed out in footnote 7 that General Dynamics “has never sought to be treated as an insurance company entitled to take IBNR deductions under the provisions of Subchapter L.”

Section 831(a) of the Internal Revenue Code provides that taxes, computed as provided in §11, are imposed for each taxable year on the taxable income of each insurance company other than a life insurance company. Section 831(c) provides that, for purposes of § 831, the term "insurance company" has the meaning given to such term by § 816(a). Under § 816(a), the term "insurance company" means "any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or reinsuring of risks underwritten by insurance companies."

Insurance companies subject to tax under § 831 of the Code are required to determine gross income under § 832(b)(1). Section 832(b)(1)(A) provides that one of the items taken into account is the combined gross amount earned during the taxable year from investment income and from underwriting income computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners (NAIC).

Section 832(b)(3) of the Code defines "underwriting income" as premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred. The term "premiums earned on insurance contracts during the taxable year" is defined in § 832(b)(4) as the amount of gross premiums written on insurance contracts during the taxable year less return premiums and premiums paid for reinsurance, plus 20% of the increase in unearned premiums.

Section 832(b)(5) defines losses incurred during the taxable year on insurance contracts as follows: (1) from the losses paid during the taxable year, deduct salvage and reinsurance recovered during the taxable year; (2) to the result so obtained, add all unpaid losses on life insurance contracts plus all discounted unpaid losses (as defined in § 846) outstanding at the end of the taxable year and deduct all unpaid losses on life insurance contracts plus all discounted unpaid losses outstanding at the end of the preceding taxable year; (3) to the results so obtained, add estimated salvage and reinsurance recoverable as of the end of the preceding taxable year and deduct estimated salvage and reinsurance recoverable as of the end of the taxable year. The amount of the unpaid losses must be fair and reasonable. Section 1.832-4(b) of the regulations provides that every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses. These losses must be stated in amounts which, based on the facts of each case and the company's experience with similar cases, represent a fair and reasonable amount the company will be required to pay.

ANALYSIS:

While § 381(c)(22), set forth above, in the context of a transaction subject to § 381(a) (such as a § 332 complete liquidation of a subsidiary into its parent corporation) provides for the carryover of items or attributes required to be taken into account for purposes of subchapter L, the statute is clear on its face that its scope is limited to situations where "the acquiring corporation is an insurance company taxable under subchapter L." (Underlining supplied.) See Section 381(c)(22). Further, § 1.381(c)(22)-(a) of the regulations (also set forth above), similarly limits the carryover of insurance attributes to acquisitions (to which § 381(a) applies) made "by a corporation which is an insurance company." (Underlining supplied.) In addition, when one examines the pattern of the examples given in the regulations under § 381(c)(22) of the Code although they deal primarily with transactions involving life insurance companies there is a common theme that only insurance companies are involved both as the transferring (or liquidating) companies and as the acquiring (or distributee) corporations. The regulations under § 381(c)(22) are clearly intended to provide guidance to certain acquisitions involving non-life insurance companies.[5]

As pointed out in General Dynamics, supra, it is clear that a non-insurance company can not deduct insurance reserves. In reaching its conclusion that General Dynamics could not "deduct incurred but not reported" claims under the "all events" test, the Court observed that this conclusion was further demonstrated by the fact that the Internal Revenue Code specifically permits insurance companies to deduct additions to reserves for such incurred but not reported claims (IBNR). The Court further indicated that if the "all events" test permitted the deduction of an estimated reserve represented claims that were incurred but not yet reported (IBNR), Congress would not have needed to maintain an explicit provision in § 832(b)(5) that insurance companies could deduct such reserves. The Court also added that General Dynamics has never sought to be treated as an insurance company entitled to take IBNR deductions under the provisions of Subchapter L. The facts are similar in the present case as the bulk of the reserve items sought to be deducted by a non-insurance company are IBNRs and Parent never sought to be treated as an insurance company entitled to take such reserve deductions. We are not, however, limiting our analysis to incurred but not reported losses (IBNRs) but to all of the Insurance Subsidiary's discounted unpaid losses. In simple terms, the present situation represents a case where, in substance, Insurance Subsidiary, as an insurance company, was entitled to take a deduction in an earlier year whereas its parent/distributee company as a non-insurance company is subject to the "all events" test and is therefore entitled to deduct the amount of the losses at a later year. Thus, our analysis is that as the losses incurred items of Insurance Subsidiary do not carry over to Parent, a non-insurance company. Accordingly, the deferral that Insurance Subsidiary enjoyed by being able to claim the benefits of § 832(b)(5)(A)(ii) must be reversed by treating Insurance Subsidiary's discounted unpaid loss balance as zero in

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[5] The regulations are clearly intended to provide guidance with respect to certain situations which primarily are non-life insurance company concerns. See § 1.381(c)(22)-(b)(14) dealing with carryovers of the special loss discount account provided for in § 847 of the Code dealing with special income tax payments.

its hands on Date A, which was the last day of its last tax year as an insurance company under Part II of subchapter L.

Section 381(c)(22) of the Code and the regulations thereunder clearly state that the carryover of insurance items or attributes is limited to transfers where the acquiring corporation is an insurance company, or in some cases a life insurance company or a particular kind of life insurance company. Further, subchapter L provides analogous examples in both Part I and Part II of subchapter L in situations where an insurance attribute or item can not carryover to the acquiring corporation. The situations that follow describe items that could not be transferred to the acquiring corporation and the item was required to be taken into account by the transferor (or distributing) corporation in the year preceding the year in which the insurance item ceased being held by a qualifying insurance company.

An illustration of this pattern of operation of subchapter L is § 807(f)(2), formerly this provision was numbered § 810(d)(2) prior to the Deficit Reduction Act of 1984 (the 1984 Act). The background of § 807(f)(2) is rooted in § 807(f)(1) (formerly § 810(d)(1) prior to the 1984 Act) which provided an adjustment (or spread) over a ten-year period resulting from a life company's change in basis for computing life insurance reserves or other item described in § 807(c) (formerly § 810(c)). Section 807(f)(2) provides, in effect, that the spread period terminates if the company is no longer a life insurance company and the adjustment is to be taken into account in the year preceding the tax year in which life insurance company status was lost. Similarly, with regard to changes in methods of accounting for insurance items maintained by non-life companies there is a positive § 481(a) adjustment that the company is required to spread over a four-year period pursuant Rev. Proc. 97-27, 1997-1 C.B. 680, and Rev. Proc. 2002-19, 2002-1 C.B. 696. Further, as a condition to the approval of a change in accounting method for such items the National Office requires that if a company ceases to be taxable as an insurance company at any time prior to the expiration of the four-year adjustment period, the company must take into account the remaining balance of the § 481(a) adjustment in the last year that it was taxable as an insurance company.

Another example is contained in § 1.381(c)(22)-(b)(7)(iv) of the regulations. This regulation provides, in part, that if the acquiring corporation is a mutual life insurance company, the dollar balances in the shareholders surplus account, policyholders surplus account, and other accounts shall not be taken into account by such acquiring corporation and the distributor corporation shall be subject to the provisions of former § 815(d)(2)(A) as of the close of the date of distribution. Former § 815(d)(2)(A) provides, in part, that except as provided in § 381(c)(22) (relating to carryovers in certain corporate adjustments) if – (i) for any year in which the taxpayer is not an insurance company, or (ii) for any two successive taxable years the taxpayer is not a life insurance company, then the amount taken into account under former § 802(b)(3) for the last preceding year for which it was a life insurance company shall be increased

(after the application of former § 815(d)(2)(B)) by the amount remaining in the policyholders surplus account at the close of such preceding taxable year.

A further example may be found under former § 824(c)(4) which provided that a mutual insurance company must include its protection against loss (PAL) account balance in taxable income as of the close of the preceding taxable year if it (or a reorganized entity) no longer qualifies as a mutual insurance company under former § 821.

CONCLUSION:

We conclude that the discounted unpaid loss items under § 832(b)(5)(A)(ii) of Insurance Subsidiary are unique to its status as an insurance company under Part II of subchapter L and such items or attributes were not an item (or attribute) that transferred to Parent, a non-insurance company, in the § 332 liquidation. Accordingly, the deferral that Insurance Subsidiary enjoyed by being able to claim the benefits under § 832(b)(5) must be reversed by treating Insurance Subsidiary's ending discounted unpaid loss balance as zero on Date A which was the last day of its last year as an insurance company taxable under Part II of Subchapter L.

We note that the examiner has argued to this office that the more specific provision, § 381(c)(22), specifically relating to successor insurance companies overrides any argument that the taxpayers may have under § 381(c)(4) which deals more generally with methods of accounting. In this connection, the examiner cited In re Weinstein, 272 F.3rd 39, 43 (1st Cir. 2001) (giving specific language precedent over general language within the same Code provision) and other cases. The examiner has made an excellent argument, however, as we have concluded that Insurance Subsidiary must reverse the benefits it previously received under § 832(b)(5) immediately prior to the § 332 liquidation we have not addressed that question because there were no § 832(b)(5) items to transfer.

CAVEAT:

As there was some uncertainty in the facts as to whether Insurance Subsidiary provided any coverage to Parent or whether Parent was acting entirely as a holding company, we are, generally, directing your attention to Rev. Rul. 2002-89, 2002-2 C.B. 984, which considered whether or not an arrangement between a domestic parent and its wholly owned insurance subsidiary was an insurance arrangement for Federal income tax purposes. However, for purposes of this memorandum, we are assuming that the parties are in agreement that for all of the years involved the transfer and distribution of insurance risk existed such that insurance existed in the arrangement for federal income tax purposes. Further, our views have not been requested and none are given with respect to that matter.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.