

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:FIP:B04

PLR-146594-13

Date:

May 16, 2014

Legend

Parent =

Taxpayer =

State 1 =

State 2 =

Department =

Business A =

Business B =

Court =

Rehabilitator =

Year =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Dear :

This is in response to the letter submitted by your authorized representatives, dated November 8, 2013, and additional submissions, requesting rulings on the Federal income tax accounting for unpaid losses under certain insurance contracts that were restructured in connection with Taxpayer's recent court-supervised rehabilitation proceeding.

FACTS

I. TAXPAYER

Taxpayer, a State 1 insurance corporation, is the direct subsidiary of Parent, a State 2 corporation. Taxpayer is a non-life insurance company within the meaning of § 831(c) of the Code. Parent files a U.S. consolidated return on behalf of an affiliated group that includes Taxpayer.

Taxpayer is regulated by Department. Taxpayer is engaged in Business A and issued insurance policies with respect to Business A (the "Policies"). The Policies were the subject of a prior letter ruling (PLR 201328027 (April 11, 2013)) in which we determined that the Policies would continue to be treated as insurance contracts under Subchapter L of the Internal Revenue Code (the "Code"). Taxpayer also engages in Business B. Policies issued with respect to Business B are not the subject of this request.

II. REHABILITATION PLAN

Beginning in the fourth quarter of Year, Taxpayer incurred significant losses on certain of the Policies, and voluntarily ceased writing new Policies in Date 1. On Date 2, Department issued an order immediately suspending further payment of any and all Policy claims by Taxpayer and prohibiting Taxpayer from writing any new policies.

Parent commenced a proceeding pursuant to chapter 11 of title 11 of the United States Code on Date 3. On Date 4, Court signed an order of rehabilitation appointing Rehabilitator as rehabilitator of Taxpayer, and commencing a court-supervised rehabilitation proceeding whereupon the Rehabilitator took control of Taxpayer pursuant to the laws of the State 1.

The Rehabilitator proposed a plan of rehabilitation dated Date 5, ("Rehabilitation

Plan”) to Court. Court approved the Rehabilitation Plan by order on Date 6. The Rehabilitation Plan became effective on Date 7, and on that same date the rehabilitation proceedings terminated.

The Rehabilitation Plan states that Department has the authority to issue certain guidelines that are binding on Taxpayer (“Department Guidelines”). Department issued such Department Guidelines to Taxpayer on Date 8.

(1) PAYMENT OF CLAIMS

Under the Rehabilitation Plan, the policyholder upon the occurrence of a covered event will receive a portion of the claim promptly and will have the right to receive the remaining portion of the claim in the future depending on Taxpayer’s financial performance and condition. The policyholder will be legally entitled to the full amount of a valid claim to the extent Taxpayer has funds available as determined under the Rehabilitation Plan. Taxpayer’s obligations to its policyholders are modified, but not discharged, by the Rehabilitation Plan. Under the Rehabilitation Plan, if a policyholder submits a valid claim and it is permitted, Taxpayer will pay the claim in the following manner: (1) a cash portion payment (“CPP”) payable promptly based on the cash payment percentage in effect at the time; and (2) a deferred portion equal to the remainder of the permitted claim (meaning, the portion of the permitted claim remaining unpaid after payment of the CPP), not currently payable under the restructured Policies, that may become payable in the future depending on Taxpayer’s financial performance and condition (“DPO”). The Rehabilitation Plan provides for accretion with respect to the DPO.

(2) STATUTORY ACCOUNTING

For statutory accounting purposes for reporting periods ending on or after Date 7, Taxpayer will adjust the way it accounts for its restructured Policies in accordance with the Rehabilitation Plan, and the Department Guidelines thereunder, including how Taxpayer records its prescribed statutory loss reserves on its annual statement. Pursuant to the Department Guidelines issued under the Rehabilitation Plan, Taxpayer establishes and maintains a “Minimum Surplus Amount.” The Minimum Surplus Amount is reflected in the annual statement that Taxpayer is required to file with Department. The reporting of the Minimum Surplus Amount ultimately decreases the amount of undiscounted unpaid losses reported by Taxpayer on its annual statement for statutory accounting purposes.

III. FURTHER REPRESENTATIONS

In addition to the facts and representations described above, Taxpayer represents that:

1. There have been no material changes to the facts upon which PLR

201328027 was based.

2. The Policies are required to be administered pursuant to the terms of the Rehabilitation Plan.
3. Taxpayer's statutory accounting is required to comply with the Department Guidelines.
4. It is not anticipated that the policyholders will receive cash payments from Taxpayer under their restructured Policies in excess of the aggregate amount of their original claims.

LAW

Section 831(c) defines an insurance company taxable under § 831 by incorporating the definition in § 816(a). Section 816(a) provides that a company qualifies as an insurance company if more than half of the company's business during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Additionally, a company need not be actively engaged in the sale of new insurance policies to qualify as an insurance company for Federal income tax purposes. See, H.R. Conf. Rep. No. 108-457, 2d Sess. 50-51 (2004) ("It is not intended that a company whose sole activity is the run-off of risks under the company's insurance contracts be treated as a company other than an insurance company, even if the company has little or no premium income.").

Section 831(a) provides that taxes, computed as provided in §11, are imposed for each taxable year on the taxable income of every insurance company other than a life insurance company. In the case of an insurance company taxable under § 831, the term "taxable income" means the gross income as defined in § 832(b)(1) less the deductions allowed in § 832(c).

Section 832(b)(1)(A) provides that the term "gross income" includes 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) provides that the term "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

The term "losses incurred" means losses incurred during the taxable year on insurance contracts computed under § 832(b)(5) as follows:

1. To 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.

I. UNPAID LOSSES

In computing “losses incurred” the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them. Treas. Reg. § 1.832-4(a)(14). The regulations issued under § 832 further provide that losses must be stated in amounts which, based upon the facts in each case and the taxpayer’s experience with similar cases, represent a fair and reasonable estimate of the amount the taxpayer will be required to pay. Treas. Reg. § 1.832-4(b).

The amount of an insurance company’s “discounted unpaid losses” is determined by discounting undiscounted unpaid losses in accordance with § 846(a). Section 846(b)(1) provides that, except as otherwise provided in § 846(b), the term “undiscounted unpaid losses” means the unpaid losses shown in the taxpayer’s annual statement. Section 846(b)(1). However, valuations of unpaid losses that are used for purposes of the NAIC annual statement are not controlling for tax purposes. Hanover Insurance Co. v. Commissioner, 598 F.2d 1211, 1217 (1st Cir. 1979); Physicians Insurance Company of Wisconsin v. Commissioner, T.C. Memo. 2001-304, * 9; Minnesota Lawyers Mutual Insurance Company v. Commissioner, T.C. Memo. 2000-203, * 14, aff’d, 285 F.3d 1086, 1091 (8th Cir. 2002); Rev. Rul. 61-167, 1961-2 C.B. 130. Taxpayers cannot meet their burden of establishing that their reserves are reasonable by simply showing that the amount of unpaid losses claimed on their return is identical to the amount reflected on their annual statement.

Unpaid losses do not include reserves for future unaccrued losses or estimates of damages the insurance company expects its insureds will suffer in the future (and for which the insurance company will eventually pay). Maryland Savings-Share Insurance Co. v. United States, 644 F.2d 16, 28 (Ct. Cl. 1981); Maryland Deposit Fund Corp. v. Commissioner, 88 T.C. 1050, 1060 (1987). Taxpayers may establish unpaid loss reserves for tax purposes only upon the occurrence of an event of default. Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858, 867-868 (7th Cir. 1992); AIG v. United States, 38 Fed. Cl. 274, 283 (1997).

II. LIMITATION ON AMOUNT OF DISCOUNTED LOSSES

The amount of the discounted unpaid losses as of the end of any taxable year is

the sum of the discounted unpaid losses computed under § 846 with respect to unpaid losses in each line of business attributable to each accident year. Section 846(a)(1). Section 846(a)(2) provides the method for discounting unpaid losses. The amount of the discounted unpaid losses as of the end of any taxable year attributable to any accident year is the present value of such losses (as of such time) determined by using: (1) the amount of the undiscounted unpaid losses as of such time, (2) the applicable interest rate, and (3) the applicable loss payment pattern. Section 846(a)(2).

Except as provided under § 846(b)(2) for discounted unpaid losses in the annual statement, "undiscounted unpaid losses" means the unpaid losses shown in the annual statement filed by the taxpayer for the year ending with or within the taxable year of the taxpayer. Section 846(b)(1).

In no event shall the amount of the discounted unpaid losses with respect to any line of business attributable to any accident year exceed the aggregate amount of unpaid losses with respect to such line of business for such accident year included on the annual statement filed by taxpayer for the year ending with the taxable year. Section 846(a)(3).

RULINGS

Based solely on the information submitted and the representations made, we rule as follows:

1. With respect to a loss incurred, the obligations to pay both the CPP and the DPO (including accretion, over time) are taken into account in computing "losses incurred" under section 832(b)(5) and Treas. Reg. § 1.832-4(b).
2. The cap on the amount of Taxpayer's discounted unpaid losses under § 846(a)(3) shall be determined without any adjustment related to unpaid losses as a result of the Department Guidelines.

CAVEATS

Except as expressly provided herein, no opinion is expressed concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by the appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

PROCEDURAL STATEMENTS

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

DONALD J. DREES, JR.
Senior Technician Reviewer, Branch 4
Office of the Associate Chief Counsel
(Financial Institutions & Products)