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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel, Field Service CC:DOM:FS

SUBJECT: Deductibility of Acquired Loss Reserves and Continuity of Proprietary Interest

This Field Service Advice supplements Field Service Advice issued November 8, 1999, in response to your memorandum dated August 9, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer =
Company A =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Date 1 =
Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =

ISSUES

1. If the merger of Taxpayer and Company A is not a tax-free reorganization under

I.R.C. § 368(a)(1)(A),[1]/ then whether Taxpayer is precluded from including in its deduction for "losses incurred" from Year 3 through Year 4, the unanticipated adverse development respecting loss reserves it assumed in connection with its acquisition of Company A.[2]/

2. Whether the extreme adverse financial position of Company A prior to its merger with Taxpayer has a significant impact on the value of any equity interest received by the former Company A policyholders in Taxpayer.

CONCLUSIONS

1. For the reasons discussed below, Taxpayer is entitled to include that unanticipated adverse development in its calculation of post-acquisition "losses incurred."

2. The extreme adverse financial position of Company A prior to its merger with Taxpayer has a significant impact on the value of any equity interest received by the former Company A policyholders in Taxpayer.

FACTS

Taxpayer is the successor in a merger transaction occurring on Date 1, pursuant to which it acquired the assets of Company A. At the time of the merger, Company A was an assuming reinsurer, i.e., a reinsurer in what apparently were a number of indemnity reinsurance transactions.

Early in Year 2, Actuary, a consulting actuarial firm, presented Company A with a report concerning a proposed transfer of outstanding losses as the end of Year 1, applicable to Company A's reinsurance activities. The report estimated the losses at that date to be approximately Amount 1, and projected approximately

Amount 2 in additional losses to be incurred in the future with respect to Company A's reinsurance treaties in force at the end of Year 1. Actuary made no projection regarding losses on reinsurance treaties that would go into effect after the end of Year 1.

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[1]/ Unless otherwise indicated, section references throughout are to the Internal Revenue Code of 1986, as amended and in effect during the taxable years at issue.

[2]/ The prior Field Service Advice, referenced above, considered whether the merger was a valid tax-free reorganization under section 368(a)(1)(A).

Company A's representative has indicated that, as of the middle of Year 5, the actual losses on Company A's book of reinsurance business have exceeded Amount 3. It is not clear how much of that amount was attributable to losses incurred on reinsurance treaties entered into after the end of Year 1.

Early in Year 2, Company A contacted certain companies and solicited offers to merge with them, with the solicited companies surviving. Other companies made unsolicited offers to merge with Company A, again with the other companies surviving. Company A merged with Taxpayer on Date 1, with Company A's policyholders receiving a cash distribution of Amount 4, less closing costs.[3]/ At that time, Taxpayer issued an "Assumption Certificate" to each Company A policyholder. The Certificate notified each former Company A policyholder that Taxpayer had assumed all of the obligations and liabilities of Company A under its (Company A's) policies.

It is not clear whether Taxpayer actually entered into a reinsurance agreement with Company A pursuant to which it assumed Company A's insurance liabilities. However, at the time Taxpayer assumed Company A's obligations in the merger in which it acquired Company A's business, Taxpayer did not intend to continue Company A's reinsurance activities. Rather, Taxpayer assumed the obligations arising in those activities in order to acquire the rest of Company A's business.

LAW AND ANALYSIS

The deductibility of acquired loss reserves in this case is relevant only if the transaction is not a valid tax-free reorganization. Therefore, for purposes of this discussion only, we will assume that the transaction is not a valid tax-free reorganization.

Property and casualty insurance companies are subject to tax under I.R.C. § 831. I.R.C. § 832 provides that taxable income of such insurers is the difference between gross income and various deductions, including "losses incurred." Section 832(b)(5) provides that "losses incurred" means "losses incurred during the taxable year" on insurance contracts, computed in part by adding all unpaid losses outstanding at the end of the taxable year and deducting unpaid losses outstanding at the end of the preceding taxable year.

Generally, where an insurance company acquires the entire business of another insurance company in a taxable transaction, the portion of the transaction

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[3]/ The Company A mutual policyholders continued to be mutual policyholders, and, therefore, mutual owners of Taxpayer.

providing for the transfer of the acquired company's outstanding insurance contract liabilities is effected through an assumption reinsurance transaction. See Kentucky Central Life Insurance Company v. Commissioner, 57 T.C. 482 (1972); Union Bankers Insurance Company v. Commissioner, 64 T.C. 807 (1975); Security Benefit Life Insurance Company v. United States, 726 F.2d 1491 (5th Cir. Year 2). See also Security Industrial Insurance Co. v. United States, 702 F.2d 1234, 1237 (5th Cir. 1983) (assumption reinsurance is the life insurance industry's functional equivalent of a direct asset acquisition).

Courts have recognized the separate tax treatment of assumption reinsurance transactions involving property and casualty insurance companies, and have applied Subchapter L rules to such transactions, even where the transaction was entered into a part of a broader corporate adjustment. For example, in Buckeye Union Casualty Company v. Commissioner, 54 T.C. 13 (1970), aff'd., 448 F.2d 228 (6th Cir. 1971), "Old Buckeye" adopted a plan of liquidation in 1965. Within 12 months of doing so, it transferred its business to "New Buckeye," and it structured a portion of the transfer as a reinsurance agreement, upon which it received an amount less than the reserves it maintained on that business.

"Old Buckeye" argued that pursuant to the provisions of I.R.C. § 337, the difference between the amount of its reserves and the amount it received in connection with the transfer of those reserves was exempt from tax. The Tax Court held that amount was subject to tax under the provisions of Subchapter L. The Court of Appeals, in affirming the Tax Court, stated [p.231]:

> [T]he substance and reality of the transaction described in the Reinsurance and Assumption Agreement was consistent with its label. The assets transferred were not sold to Continental Buckeye, they were paid to it as consideration for its assumption of taxpayer's liabilities and for Continental's reinsurance of the policies then on the books.

448 F.2d 228 at 231.

Similarly, in Jerome H. Stern et .al. v. Commissioner, 66 T.C. 91 (1976), a reinsurance transaction was effected in the course of a cash merger which did not qualify as tax free under section 368(a)(1)(A) due to a lack of continuity of interest. The court determined that the reinsurance transaction should be accounted for separately from the purchase and sale of the business, and held that the acquiring company could claim a deduction for the ceding commission.[4]/ separately from the

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[4]/ In Stern, although the assuming company succeeded to all of the ceding company's liabilities on the date of the merger, the reinsurance agreement covered only liabilities for unpaid losses arising after its effective date. While it is reasonable to assume that the assuming company included the merged company's unpaid loss reserves as of the date of the merger in its own unpaid loss reserves, the case does not

purchase and sale of the business, and held that the acquiring company could claim a deduction for the ceding commission.[5]/

In a number of cases involving transfers of nonlife insurance business through assumption reinsurance, courts have acknowledged that the assuming company was to be treated as having received an insurance premium and was entitled to set up insurance reserves with respect to the business it acquired. The courts in those cases did not distinguish between reserves for unpaid losses that had been incurred prior to the relevant agreement and other reserves. See Hoosier Casualty Company v. Commissioner, 32 F.2d 940 (D.C. Cir.1929); Kentucky Central Life Insurance Company v. Commissioner, supra; Union Bankers Insurance Company v. Commissioner, 64 T.C. 807 (1975); and, Commonwealth Title Company of Philadelphia v. Mayer, 124 F. Supp. 274 (E.D. Pa. 1954). See also PLR 9228003 (March 26, 1992), in which the Service agreed that a loss portfolio reinsurance transaction constituted insurance for tax purposes.

Finally, Congress expressed its views regarding the applicability of the assumption reinsurance rules to a deemed transfer of insurance policies occurring by reason of an I.R.C. § 338 election during its deliberations regarding the enactment of I.R.C. § 197. Section 197 provides an amortization deduction for certain intangible property, including the value of insurance in force acquired by means of an assumption reinsurance transaction. See I.R.C. § 197(f)(5). The legislative history of that section states that the principles of Treas. Reg. § 1.817-4(d), relating to assumption reinsurance transactions apply for purposes of determining the amortizable basis of insurance in force acquired in an assumption reinsurance transaction, including any acquisition of an insurance contract occurring by reason of a section 338 election. H. Rep. No. 11, 103d Cong. 1st Sess. 760, 775, fn.150 (1993), 1993-3 C.B. 167, 351; H. Conf. Rep. No. 213, 103d Cong. 1st Sess. 675, fn. 25 (1993), 1993-3 C.B. 393, 565. Although the instant case does not involve a section 338 election, it does involve a taxable purchase of assets, which is deemed to occur under section 338(h)(10(A)(ii).

In a case where a company transfers its insurance business to another company in a cash merger, Subchapter L requires that as long as the merged company pays fair and reasonable consideration to the surviving company to

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indicate whether the Service challenged the deductibility of any portion of that reserve.

[5]/ In Stern, although the assuming company succeeded to all of the ceding company's liabilities on the date of the merger, the reinsurance agreement covered only liabilities for unpaid losses arising after its effective date. While it is reasonable to assume that the assuming company included the merged company's unpaid loss reserves as of the date of the merger in its own unpaid loss reserves, the case does not indicate whether the Service challenged the deductibility of any portion of that reserve.

assume its risks, the reinsurer should be entitled to revalue its losses each year in the same manner as any other insurance company.

Thus, in the instant case, the amount Taxpayer received (or is deemed to have received) from Company A to assume the latter's insurance liabilities, including liabilities for unpaid losses, constituted an insurance premium that Taxpayer was entitled to include in its reserve for unpaid losses, the Company A unpaid losses to which it succeeded on account of the merger; and that in Year 1 through Year 4, Taxpayer was entitled to increase or decrease those reserves, as appropriate.

You have raised an argument that Pacific Transport Co. v. Commissioner, 483 F.2d 209 (9th Cir. 1973), supports the respondent's position. Pacific Transport deals with the assumption of a subsidiary's contingent liabilities by the parent corporation upon the liquidation of the subsidiary. Neither the parent nor the subsidiary, however, in Pacific Transport were insurance companies. As such, Pacific Transport is factually distinguishable from the instant case and should not be relied upon.

You have also raised an argument that payments Taxpayer made with respect to liabilities Company A incurred on its reinsurance contracts and attributable to losses occurring prior to the date of the merger, do not constitute deductible expenses, but rather constitute additions to Taxpayer's basis in the assets it acquired from Company A.[6]/ In this context, however, neither the Service nor the courts have distinguished between loss events before and after the date of the assumption reinsurance transaction.

You have also raised an argument that International Life Insurance Company v. Commissioner, 427 F.2d 137 (6th Cir. 1970), aff'g per curiam, 51 T.C. 765 (1969) is relevant to the disposition of this case. In that case, pursuant to a reinsurance agreement, International Life acquired the policies of an insolvent insurer. In connection with the acquisition, International Life received approximately $88,500, and deducted $174,300 as an expense characterized as "paid for business acquired." The Service asserted that the entire amount International Life received constituted ordinary income, but that the company was entitled to deduct no portion of the $174,300 in liabilities it assumed. In a holding without analysis, the court determined that the loss reserves acquired from the insolvent insurer should be characterized as a cost of the acquisition rather than as a liability.

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[6]/ The tax liabilities of Company A and/or its policyholders are not at issue in this case. Therefore, we do not address the consequences to either Company A or its policyholders if the payments Taxpayer made were deemed to be additional amounts paid for Company A's assets.

We conclude that International Life is not relevant to the instant case. First, it was decided 30 years ago and related to tax years prior to the 1959 Act. Second, it did not involve the treatment of additions to loss reserves in tax years after the acquisition. Finally, and most importantly, the implication in International Life that somehow a reinsurance transaction pursuant to which an insurance business is transferred to a new company should be bifurcated between the portion of the transaction dealing with insurance liabilities that might arise in the future, and liabilities that have arisen in the past, is inconsistent with the analysis reflected in Buckeye Union Casualty Company, supra; Hoosier Casualty Company, supra; Kentucky Central Life Insurance Company, supra; Union Bankers Insurance Company, supra; and, Commonwealth Title Company of Philadelphia, supra.

For the foregoing reasons, we conclude that Taxpayer is entitled to include that unanticipated adverse development in its calculation of post-acquisition "losses incurred."

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Please call if you have any further questions.

Deborah A. Butler
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By: ____________________________
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