

INTERNAL REVENUE SERVICE

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September 30, 1999

Liquidator of the Estate =  
Company A =  
Parent B =  
Date C =  
State D =  
Reinsurer E =  
Date F =  
Court G =  
Year H =  
Law I =  
Date J =  
Date K =  
Date L =

Dear

This is in response to the ruling request of Date C, as supplemented, submitted by the Acting Director of Insurance of State D as Liquidator of the Estate of Company A regarding the federal tax treatment under the Internal Revenue Code of certain transactions described below. This request supplements rulings previously given to this taxpayer in a private letter ruling dated January 8, 1999 (PLR 199915025).

Company A is a State D stock life insurance company which is owned 100 percent by Parent B. Company A, its subsidiaries, and Parent B and Parent B's other subsidiaries filed a life/non-life consolidated return for Year H, but have not filed a return since that date.

In Year H, Company A developed financial difficulties. On Date F, by an Agreed Order of Liquidation with a Finding of Insolvency (the Order), Court G of State D placed Company A and its subsidiaries into receivership. The Court also appointed the Liquidator of the Estate to take possession of the property, business and affairs of the company to liquidate Company A. Company A's liquidation has not yet been completed as it retains assets that will be used in due course to pay a portion of its liabilities.

The Order ruled specifically that Company A was insolvent. The Order further provided that the rights and liabilities of the creditors, policyholders, and stockholders of Company A became fixed as of the date of the Order. The Order went to explicitly cancel

all direct policies or contracts of insurance heretofore issued by Company A...except those policies or contracts of insurance which are "covered policies" within the meaning of the State D Law I..., or the obligations, or any part thereof, of which the State D Life and Health Guaranty Association [the Association], or any similar organization in any other state, is obligated to assure payment of, which shall remain in full force and effect until canceled, or until they expire, in accordance with their terms.

A "covered policy" is defined under State D law as any policy or contract within the scope of the Life and Health Guaranty Association Article of the Insurance Code. The relevant provisions generally provide coverage and limitation guidelines to persons who were policyholders of Company A prior to the date of the Order. The State D Insurance Code applies to policyholders domiciled in State D. The provisions further state that all premiums due for coverage after entry of an order of liquidation of an insolvent insurer shall belong to and be payable at the direction of the State D Association, and that the State D Association shall be liable for unearned premiums due to policy or contract owners arising after the entry of such order.

As part of the State D Association's role in the liquidation of Company A, the Association was required by State D statute to (1) guarantee, assume or reinsure or cause to be guaranteed, assumed, or reinsured the covered policies of covered persons of the insolvent insurer; (2) assure payment of the contractual obligations of the insolvent insurer to covered persons; (3) provide such monies, pledges, notes, guarantees, or other means as are reasonably necessary to discharge such duties, or (4) with respect to only life and health insurance policies, provide benefits and coverages in accordance with the statutory rules of State D. Notice was given to the policyholders that premiums for post-Order coverage should be submitted directly to the State D Association. Any premiums sent or delivered to the Liquidator of the Estate by the policyholders for post-Order coverage were forwarded to the appropriate state guaranty associations.

The Liquidator of the Estate has represented that the effect of the State D statutes, in combination with the cancellation of all uncovered contracts and policies under the Order, was that Company A no longer had any rights, obligations, or other responsibilities with respect to the covered contracts after Date F. The Liquidator of the Estate further represents that all premiums due thereafter were to be paid to the appropriate state guaranty associations which were likewise liable for any benefits or claims due or payable after Date F, according to their respective state statutes. After Year H, the only business of the Liquidator of the Estate was to value the remaining assets, to resolve all claims, and (after all litigation was concluded), to use the liquidated assets to pay creditors to the extent possible.

A one page estimate of the aggregate claim liability by Company A to its policyholders (the Tentative Claim Liabilities) as of Date F was prepared, apparently concurrently with the Order. Two years later, on Date J, the Liquidator of the Estate

filed a motion with Court G for approval of his recommendations as to the methodology to be employed in evaluating policyholder values as of Date F. The following year, almost three years after issuance of the original insolvency Order, the method was approved by an order of Court G dated Date K. The determination of the total claim liabilities as of Date F using the approved method is still being reviewed by the policyholders, the Association (and similar associations in other states), but is expected, in due course, to be approved by Court G at the conclusion of the liquidation. These liabilities are hereinafter referred to as Final Claim Liabilities. The Liquidator of the Estate has represented that the Final Claim Liabilities are anticipated to be either the same or greater than the Tentative Claim Liabilities as of Date F, but that it is possible that the Final Claim Liabilities may be less than the Tentative Claim Liabilities.

The Estate of Company A continued to be in the insurance business during its liquidation although it no longer qualified for treatment as a life insurance company for federal tax law purposes after Date F. We have ruled previously, based on the facts submitted and the representations made at that time, that any insurance premiums paid for coverage subsequent to Company A's Year H taxable year are not includible in the income of the Estate of Company A.

The Estate of Company A filed a federal tax return for Year H, which tax year is now closed and not at issue. However, the Estate of Company A was entitled to a deduction in Year H, under section 805(a)(1), for all claims and benefits accrued, and all losses incurred (whether or not ascertained) on insurance and annuity contracts during Year H, which amount would have included the Tentative Claim Liabilities.

Rev. Rul. 84-170, 1984-2 C.B. 245, holds that, under section 6012(b)(2) [formerly section 6012(b)(3)] of the Internal Revenue Code, the liquidator of the estate of an insolvent insurance company must file a federal income tax return for the insurer so long as the insurer is considered to continue in existence for federal tax purposes. The liquidator must file the return for the period that the liquidator continues to have possession of or title to the property of the insurer.

Rev. Rul. 63-104, 1963-1 C.B. 172, holds, in part, that an affiliated group of corporations, which has filed consolidated returns for prior taxable years, is required to file a consolidated return for a subsequent taxable year even though a member of the group is involved in bankruptcy proceedings and the trustee in bankruptcy fails or refuses to file a Form 1122 consenting to the filing of such a return.

Rev. Rul. 69-405, 1969-2 C.B. 240, holds that an insurance company is no longer entitled to file as a life insurance company once it no longer has life insurance reserves even though its sole business is that of winding up its life insurance business. This revenue ruling is consistent with the requirements of current section 816 as to qualification of an insurance company as a life insurance company although it assumes that the non-life insurance company will file a Form 1120. At the time that this ruling was issued, Form 1120-PC was not yet available and insurance companies other than

life insurance companies filed a Form 1120. As a result, the ruling fails to specify the use of Form 1120-PC which is now required to be used by insurance companies that are not life insurance companies.

As of Date F, the tax treatment of the cancellation of the uncovered contracts and what was effectively an assumption reinsurance of the covered contracts by the participating guarantee associations on that date was appropriately treated under Part I of Subchapter L of the Code. The adjustments produced by the difference between the Tentative Claim Liabilities and the Final Claim Liabilities will occur, however, in a later year when the Estate of Company A's only business is that of winding up and liquidating its prior life insurance business, an activity that does not qualify the Estate of Company A for treatment as a life insurance company under Part I of Subchapter L. Accordingly, the adjustments occurring after Year H are properly handled under Part II of Subchapter L and returns are to be filed on Form 1120-PC. This conclusion is consistent with that reached in Rev. Rul. 69-405.

In the case of an increase in the amount of liabilities to the policyholders over the Tentative Claim Liabilities, the analog to section 805(a)(1) in Part II is section 832(b)(5)(A)(i) which defines losses incurred to include losses paid during the taxable year which amount, in this case, will consist of the excess amount (if any) paid by the Estate of Company A over the amount of Tentative Claim Liabilities determined in Year H and deductible at that time under section 805(a)(1).

Section 108(a)(1)(B) provides that gross income does not include any amount by reason of the discharge of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent. The amount excluded under section 108(a)(1)(B) is limited to the amount by which the taxpayer is insolvent. Section 108(a)(3). Section 108(e)(1) provides that, except as otherwise provided in section 108, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness. Section 108(e)(2) provides that no income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction. The general rules of section 108(e) apply for purposes of all the provisions of the Code.

Section 108(d)(1) defines the term "indebtedness of the taxpayer" to mean any indebtedness for which the taxpayer is liable. A "discharge of indebtedness" is defined under section 1.61-12(a) as the payment or purchase of a taxpayer's obligations at less than fair value.

Section 805(a)(1) provides that a life insurance company is entitled to a deduction for all claims and benefits accrued, and all losses incurred (whether or not ascertained) during the taxable year on insurance and annuity contracts.

Section 1.809-5 of the regulations (concerning prior section 809(d)(1), the predecessor to section 805(a)(1)) states that all claims and benefits accrued (less

reinsurance recoverable) and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts (including contracts supplemental thereto). The term "all claims and benefits accrued" includes, for example, matured endowments and amounts allowed upon surrender. The term "losses incurred (whether or not ascertained)" includes a reasonable estimate of the amount of the losses (based upon the facts in each case and the company's experience with similar cases) incurred but not reported by the end of the taxable year as well as losses reported but where the amount thereof cannot be ascertained by the end of the taxable year.

The Estate of Company A has a contractual obligation to its contract holders to pay the benefits provided under the contracts it has either issued or assumed (through reinsurance). The Estate of Company A has previously represented that, when Court G issued its order on Date E, the contractual obligations of the Estate of Company A were both fixed in amount (although not ascertained) and terminated by operation of State D law. Accordingly, after Year H, the Estate of Company A's sole obligation to its policyholders was its own debt obligation. The maximum value of the debt obligation was determined to be the Tentative Claim Liabilities amount in Year H and will be the Final Claim Liabilities amount as determined by Court G. The Estate of Company A will satisfy a portion of the Final Claim Liabilities. To the extent that the Estate of Company A is insolvent at that time, the State A court is expected to discharge the Estate of Company A from its liability to pay the portion of the Final Claim Liabilities due to the contract holders that cannot be paid due to lack of assets.

With respect to the discharge of the indebtedness to the contract holders, the Estate of Company A will realize income from discharge of indebtedness under section 61(a)(12) at the time that its obligations to the contract holders, measured by the Final Claim Liabilities determined by Order of Court G, are discharged by Court G or other State D court having jurisdiction over the insolvency proceeding. However, the Estate of Company A will not recognize income upon the discharge of indebtedness under section 108 provided that the Estate of Company A is insolvent when the discharge occurs and will not become solvent as a result of the discharge.

Based on the facts submitted and the representations made, we hold as follows:

1. The Estate of Company A holds no life insurance reserves as of January 1, Year L.
2. Pursuant to Rev. Ruls. 63-104, 69-405, and 84-170, the Estate of Company A must file a return on Form 1120PC (taking into account its continued consolidation or lack thereof) for tax years subsequent to Year H until its liquidation is complete.
3. The Final Claim Liabilities, when approved by Court G, will not be deductible by the Estate of Company A in any taxable year subsequent to Year H, to the extent that the Tentative Claim Liabilities were accrued and deductible by the Estate of

Company A in Year H. If the Final Claim Liabilities exceed the Tentative Claim Liabilities previously deductible in Year H, the portion of the excess that is paid will be deductible under section 832(b)(5)(A)(i) in the year paid, while the unpaid excess will, in the year approved by Court G, be an unpaid loss subject to section 832(b)(5)(A)(ii). If the Final Claim Liabilities are less than the Tentative Claim Liabilities previously deductible in Year H, the reduction in liabilities shall be includible in income except to the extent that section 108 applies.

4. The Estate of Company A will not recognize income by reason of section 108 as a result of Court G's discharge of Final Claim Liabilities that remain unpaid after all distributions to creditors and policyholders, but non-recognition applies only to the extent that the Estate of Company A is insolvent at the time of such discharge.

No opinion is expressed as to the federal tax treatment of the Estate of Company A under other provisions of the Code and income tax regulations which may also be applicable thereto. We also are not ruling as to the federal tax consequences of the described transactions upon any other parties.

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.

A copy of this letter should be attached to the federal income tax return to be filed by the Estate of Company A for taxable year subsequent to Date L.

Sincerely yours,  
Assistant Chief Counsel  
(Financial Institutions & Products)

By: /S/  
Donald J. Drees, Jr.  
Senior Technician Reviewer  
Branch 4