

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:CORP:B01

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Date:

March 12, 2014

Legend

Parent =

Sub =

Department =

Rehabilitator =

Business A =

Business A1 =

Contracts =

Court =

State A =

Account =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

aa% =

\$bb =

Dear :

This letter responds to a letter dated September 11, 2013 from your authorized representative requesting rulings on certain federal income tax consequences under sections 832 and 1504 of the Internal Revenue Code. The information submitted in that request and in later correspondence is summarized below. This letter supersedes the letter dated March 10, 2014.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings. Verification of the information, representations, and other data may be required on examination.

SUMMARY OF FACTS

Parent is a holding company and is the common parent of an affiliated group of corporations filing a consolidated federal income tax return (the "Parent Group"). Parent owns all of the common stock of Sub, a State A insurance company subject to regulation by Department. Sub has outstanding a class of preferred stock, all of which

is owned by third parties. Sub is a member of the Parent Group and primarily is engaged in Business A. Sub also is engaged in Business A1.

In response to Sub's deteriorating financial condition and at the request of Department, Sub established Account on Date 1 in order to conduct an orderly run-off of the insurance policies (the "Policies") and other liabilities allocated to Account. Approximately aa% of Sub's assets were allocated to Account. Further, a series of agreements allow Account to draw on Sub's assets not allocated to Account, so long as the claims do not reduce Sub's statutory surplus below \$bb. For purposes of this letter ruling, the Policies include all insurance policy obligations allocated to Account, but specifically exclude any Contracts allocated to Account.

Also on Date 1 and at the request of Department, Court entered an Order for Rehabilitation, placing Account into rehabilitation pursuant to State A statute. Court appointed Rehabilitator as the rehabilitator of Account. Additionally on Date 1, Court imposed a moratorium on claim payments by Account with respect to the liabilities allocated to Account (the "Moratorium"). Notwithstanding the Moratorium, Sub's policyholders must continue to pay premiums on those Policies that provide for an installment premium; a failure to pay premiums on such a policy will invalidate claims submitted under that policy from and after the date the premiums are due and payable yet unpaid.

On Date 2, Rehabilitator submitted a rehabilitation plan to Court. Court approved the rehabilitation plan on Date 3. However, the implementation of the rehabilitation plan has been deferred due to litigation, recent developments regarding claims, and other factors. As a result of these factors, the Rehabilitator expects to file amendments to the rehabilitation plan (as amended, the "Rehabilitation Plan"), and the Rehabilitation Plan will become effective only after Court has approved any such amendments.

Under the Rehabilitation Plan, the Policies are restructured. Under these restructured Policies, a policyholder, upon the occurrence of a default event, may submit a claim to Sub for the defaulted amount. Upon Sub's review and approval of a claim (subject to the direction of the Rehabilitator), the restructured Policies will require Sub to pay a portion of such claim from Account (the "Interim Payments"). With respect to the unpaid balance of the claim, no payment will be made until Rehabilitator determines that additional payments may be made. The Rehabilitation Plan will provide for accretion on the unpaid balance of each approved claim. The unpaid balance of an approved claim upon which an Interim Payment has been made, including accretion, is the "Deferred Amount" of such claim.

Under the Rehabilitation Plan, a default event in the restructured Policies will be the same as under the original contract. In addition, the Rehabilitator has informed Parent that other material terms and conditions of the Policies will remain the same: the parties

to the Policies will remain the same and the policyholders must continue to make premium payments in the same manner as under the original policy terms.

Once approved, the Rehabilitation Plan will apply to all claims under the Policies other than those paid in full prior to the date the Moratorium began. Notwithstanding the deferred effective date of the Rehabilitation Plan, Court permitted Account to make Interim Payments with respect to certain claims that were approved from the inception of the Moratorium through Date 4. These Interim Payments began on Date 5.

Under State A law, the rehabilitation proceeding is designed to protect the interest of insureds, creditors, and the public generally. To this end, Rehabilitator, subject to the supervision of Court, took possession of the assets allocated to Account and manages the assets and liabilities allocated to Account with all of the powers of the officers and managers of Sub, with the aim to reform and revitalize Sub. When Rehabilitator finds that the rehabilitation has been accomplished, it may petition Court to terminate the rehabilitation and to return control over the assets and any remaining liabilities allocated to Account to Sub.

During the pendency of the rehabilitation and after the effective date of the Rehabilitation Plan, Sub's board of directors continues to oversee Sub's business operations, including management and decision-making authority over Sub's assets not allocated to Account. Parent retains the right to elect and remove members of Sub's board of directors and Parent retains all economic benefits arising from ownership of Sub's common stock. Rehabilitator does not have any power to control Sub's board of directors, nor does Rehabilitator participate in Sub's governance, other than through control and decision-making authority over Account.

REPRESENTATIONS

The taxpayer makes the following representations:

1. Parent owns at least 80% of the voting power and value of Sub's stock (except the Preferred Stock).
2. The Policies qualified as insurance contracts for federal income tax purposes from the date of issuance through the commencement of the Rehabilitation.
3. For statutory accounting purposes, Sub accrues liabilities for estimated payment obligations only where default has occurred (the "Default Method"). Department has informed Sub that Sub should expect to use the Default Method with respect to the Deferred Amounts created under the Policies as restructured pursuant to the Rehabilitation Plan.

4. For all periods of Sub's existence, more than 50% of its business consisted of the issuance of insurance contracts or the administration and management of previously issued insurance contracts.

ANALYSIS

Section 831(c) defines an insurance company taxable under section 831 by incorporating the definition in section 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.").

Neither the Code nor the regulations define the term "insurance" or "insurance contract" for federal income tax purposes. However, case law interprets these terms. In Helvering v. Le Gierse, 312 U.S. 531 (1941), the Supreme Court described insurance as amounts

received as a result of a transaction which involved an actual 'insurance risk' at the time the transaction was executed. Historically and commonly insurance involves risk-shifting and risk-distributing. ... That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators.

Id. at 539. Subsequent cases, in analyzing whether premiums paid to captive insurance companies are deductible, have described the Le Gierse definition of insurance as a three-part test. Under that three-part test, the following elements must be met to constitute insurance for federal income tax purposes: (1) the transaction must involve insurance risk, (2) the arrangement must provide both risk-shifting and risk-distribution, and (3) the arrangement must be insurance in its commonly accepted sense. Amerco, Inc. v. Commissioner, 979 F.2d 162, 165 (9th Cir. 1992), citing the tax court opinion 96 T.C. 18 (1991); see also Harper v. Commissioner, 96 T.C. 45 (1991), aff'd 979 F.2d 1341 (9th Cir. 1992).

Section 831(a) provides that taxes, computed as provided in section 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 section 831, the term "taxable income" means the gross income as defined in section 832(b)(1) less the deductions allowed in section 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 section 832(b)(5) as follows:

- (i) To losses paid during the taxable year, deduct salvage and reinsurance recovered during the taxable year.
- (ii) To the result so obtained, add all unpaid losses on life insurance contracts plus all discounted unpaid losses (as defined in section 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.
- (iii) 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.

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 section 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 section 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. 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).

RULINGS

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

1. Neither the appointment of Rehabilitator as rehabilitator of Account, the adoption of the Rehabilitation Plan requiring Interim Payments and establishing Deferred Amounts under the Policies, nor the entitlement of policyholders to Deferred Amounts has resulted or will result in a disaffiliation of Sub from Parent under section 1504(a)(2).
2. The Policies that are restructured under the Rehabilitation Plan will be treated as insurance contracts under Subchapter L of the Code.
3. With respect to a loss incurred under the Policies, the obligations to pay both the Interim Payments and the Deferred Amounts (including accretion, over time) are taken into account in computing "losses incurred" under section 832(b)(5) and Treas. Reg. § 1.832-4(b).

CAVEATS

Except as expressly provided herein and specifically set forth in the rulings above, no opinion is expressed or implied concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter under any other provision of the Code and regulations.

PROCEDURAL STATEMENTS

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

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

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

Sincerely,

Mark S. Jennings
Branch Chief, Branch 1
Associate Chief Counsel (Corporate)