OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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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: Continuity of Proprietary Interest

This Field Service Advice responds 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:

X =
Y =
X policyholders =
Certain Other Entities =

Jurisdiction A =
Jurisdiction B =
Year 0 =
Year 1 =
Year 2 =
Year 3 =

Year 4 =
Years 2 through 5 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 = _____________
B =
C =
$b to $c =
$d to $e =
$f =
$g =
$h =
$i =
$j =
$k =
$l =

ISSUE 1:

Whether the merger of X into Y fails to qualify as a reorganization under I.R.C. § 368(a)(1)(A) for lack of continuity of interest.

CONCLUSION 1:

[redacted]

ISSUE 2:

If the transaction is not a valid tax-free reorganization under section 368(a)(1)(A), whether Y is entitled to deductions for “losses incurred” for the “unanticipated adverse development” to the loss reserves assumed by Y as part of the X acquisition.

CONCLUSION 2:

[redacted]

FACTS:

Petitioner claimed deductions for "losses incurred" relating to the acquisition of X in each of the taxable years in controversy. For Years 2 through 4, petitioner also claimed deductions relating to the X acquisition for loss adjustment expenses, a reserve for unpaid losses, and for net operating loss deductions. The primary issue is whether the Commissioner's disallowance of these losses/expenses relating to Y's Year 1 acquisition of X should be sustained. Respondent's disallowance of these losses/expenses is based on the argument that the merger transaction at issue failed to qualify as a tax-free reorganization under section 368(a)(1)(A) for lack of continuity of interest. If correct, petitioner is not entitled to the benefits associated with a tax-free reorganization. Respondent is also arguing that petitioner is not entitled to claim deductions for "losses incurred" for the unanticipated adverse development to the loss reserves assumed by Y as part of the X acquisition.

X was a mutual insurance company organized in Jurisdiction A, and Y was a mutual property and casualty ("P&C") insurance company organized in Jurisdiction B. On Date 1, Y acquired X. Y was licensed to write most lines of P&C insurance, but generally restricted its coverage primarily to commercial property insurance.

In addition to the reinsurance agreement entered into by the companies, X entered into agreements to reinsure policies written by insurance companies outside the B. These outside agreements entered into by X as a reinsurer were not covered by the reinsurance agreement entered into with the other companies. X referred to its reinsurance business transacted outside the system as "professional reinsurance."

By late Year 0, due to the drain on the company resulting from X's professional reinsurance business, a decision was made that the company would need to enter a merger, or other strategic alliance, to avoid bankruptcy. In late Year 0, X retained a party to provide financial advisory services and a valuation of X as of Date 2. This party's valuation concluded that X's value was between $b to $c. However, respondent's valuation expert arrived at a preliminary conclusion that without taking into account adjustments to X's professional reinsurance reserves, the actual value of X at the time of the merger was $d to $e.

Respondent's expert gave a preliminary opinion that X was "underreserved" in Year 1 when it came to projecting the professional reinsurance losses of X. Once this factor is included in the analysis, he opined that X was insolvent at the time of its acquisition by Y. Petitioner's counsel indicated that, as of Date 3, the actual losses generated from X's book of professional reinsurance, which was assumed by Y following the acquisition of X, exceeded $f.

Effective Date 2, X's portfolio of assumed reinsurance business was transferred to C. had a certain maximum liability limit of premiums paid, up to a maximum of j. X's premium payable to C was k, plus additional premiums received by X subsequent to the effective date. X remained responsible for additional reinsurance written after the effective date of the agreement with C, but prior to the date of the X merger.

For Years 2 through 5, Y claimed deductions for "losses incurred" relating to the X acquisition. For Years 2 through 4, Y also claimed deductions relating to the X acquisition for loss adjustment expenses, a reserve for unpaid losses, and for net operating loss deductions.

In Date 4, the president and CEO of X contacted Y and other parties soliciting offers to merge with or acquire the assets and liabilities of X. Y and the other parties each responded to the solicitation by making offers to acquire X.

Y submitted its proposal to merge with X on Date 5. Effective as of Date 1, X merged into Y. On Date 6, Y issued an "Assumption Certificate" to each X policyholder. The Assumption Certificate notified each former X policyholder that Y had assumed all of the obligations and liabilities of X under its policies, and that the insured was now a member of Y.

Under the terms of the Agreement for Merger, the members of X who were policyholders on both Date 7 and on the effective date of the merger, were eligible to one or more cash distributions to be made subsequent to the effective date of the merger. Specifically, the Agreement for Merger provided for first cash distribution of g, and a second cash distribution, dependent upon the availability of stop-loss reinsurance with a limit of not less than $l, covering losses assumed by X under certain pre-merger professional reinsurance contracts. The first cash distribution to former X policyholders was made on Date 8 in the amount of $h. No second cash distribution was made to the former X policyholders since the conditions for that distribution were not satisfied.

ISSUE #1

LAW:

A reorganization under I.R.C. § 368(a)(1)(A) is defined as a statutory merger or consolidation.

Under Treas. Reg. § 1.368-1(b), a transaction cannot be a reorganization unless there is a continuity of interest by the persons who directly or indirectly owned the business enterprise prior to the transaction. This provision reflects the judicially developed doctrine enunciated by the Supreme Court's requirement in Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933), that the "the seller must acquire an interest in the affairs of the purchasing company" for the transaction to qualify as a reorganization. The Court subsequently refined this requirement in Helvering v. Minnesota Tea Co., 296 U.S. 378, 385 (1935), adding that the interest in the purchasing company "must be definite and material" and "represent a substantial part of the value of the thing transferred." The purpose of this requirement is to limit tax-free treatment to those transactions that represent a continuation of the investment by the acquired corporation's shareholders in modified corporate form. Cf. Treas. Reg. § 1.1002-1(c) (nonrecognition of gain in reorganization assumes new corporate structure is substantially continuation of old "still unliquidated"). In the case of a bankrupt corporation, the creditors of the bankrupt corporation may be treated as the former shareholders of the transferor corporation for purposes of the continuity of interest requirement. See Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 183-184 (1942).

In Norman Scott, Inc. v. Commissioner, 48 T.C. 598 (1967), Mr. and Mrs. Scott owned approximately 99% of the stock of Norman Scott, Inc. ("NSI") and two other corporations, Houston Continental Motors Ltd. ("Continental") and River Oaks Motors, Inc. ("River Oaks"). All three corporations were engaged in the sale and servicing of foreign automobiles. On July 31, 1961, Continental and River Oaks merged under state law into NSI, which was the surviving corporation. Under the terms of the merger, the shareholders of Continental and River Oaks received stock of NSI. At the time of the merger, Continental and River Oaks had both ceased acquiring new inventory, and both had liabilities in excess of the fair market value of their assets.

The Service argued in Norman Scott that the merger of Continental and River Oaks into NSI was not a reorganization under I.R.C. § 368(a)(1)(A) because Continental and River Oaks were insolvent on the date of the merger and their stock was therefore worthless. Under this argument, the stockholders of Continental and River Oaks could not have received a proprietary interest in NSI. The Tax Court disagreed with the Service and held that the merger qualified as a valid reorganization, finding that it was sufficient that the Scotts received stock of NSI in the merger either as stockholders of Continental and River Oaks or as creditors of the two insolvent corporations. In the court's view, a creditor of an insolvent corporation qualifies as having a proprietary interest in the corporation, citing Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942). In Alabama Asphaltic, the creditors of the insolvent corporation took steps to enforce their claims.

The Service acquiesced in the result in Norman Scott, agreeing with the holding that the merger of the two insolvent corporations into NSI was a reorganization under I.R.C. § 368(a)(1)(A). See GCM 33859 (June 25, 1968).[1] The GCM concurred with the acquiescence.

The GCM indicates that insolvency alone does not preclude such a merger from qualifying as a reorganization where the shareholders of the insolvent corporation receive a proprietary interest in exchange for the corporation's assets. In particular, it notes that insolvency does not mean that the shareholders' equity interest is worthless because the corporation may have prospective value as an ongoing business that is not reflected on the corporation's balance sheet.

ISSUE #2:

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

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[1] An Action on Decision, dated December 7, 1967, was prepared and released, and a subsequent GCM, dated June 25, 1968, agrees with the recommended acquiescence in result, but disagrees with the rationale stated in the AOD. However, the acquiescence was apparently not announced in the Cumulative Bulletin.

Property and casualty insurance companies are subject to tax under I.R.C. § 831. I.R.C. § 832 provides that taxable income for 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.

Case law supports an argument that, as a general matter, unanticipated liabilities acquired in a reorganization should be characterized as a cost of the acquisition rather than as a liability. Pacific Transport Co. v. Commissioner, 483 F.2d 209 (9th Cir. 1973). Case law also supports an argument that the same result occurs in the specific context of Subchapter L at issue in this case, i.e., that loss reserves acquired from an insolvent insurer should be characterized as a cost of the acquisition rather than as a liability. International Life Insurance Co. v. Commissioner, 427 F.2d 137 (6th Cir. 1970), aff'g 51 T.C. 765 (1969).

CASE DEVELOPMENT, LITIGATION HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

[redacted]

[redacted][2] [redacted]

[redacted][3]

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[2] [redacted]

[3] [redacted]

[redacted]

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4 [redacted]

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[redacted][5] [redacted]

If you have any further questions, please call (202) 622-7930.

Deborah A. Butler
Assistant Chief Counsel

By: ______________________

[5]/ [redacted]

ARTURO ESTRADA
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