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Department of the Treasury

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:CORP:2 - PLR-111190-99
Date: February 16, 2000

Re:

Taxpayer	=	
Attorney-in-Fact Company	=	
	=	
Sub	=	
State A	=	
State B	=	
Business C	=	
Date D	=	
Date E	=	
Date F	=	
Type G insurance	=	
State A Statute	=	
a	=	
b	=	
c	=	

d%	=
Stock Exchange	=

This is in response to a letter dated June 18, 1999, in which you requested rulings on behalf of Taxpayer with respect to a proposed transaction. Additional information was received in letters dated September 23, 1999, December 9, 1999, December 17, 1999, and January 17, 2000. The information submitted is summarized below.

Taxpayer is a non-stock reciprocal insurance exchange organized under State A law that provides certain insurance products to certain individuals and to certain corporate and partnership entities and a variety of other entities engaged in Business C. Taxpayer is an association taxable as a corporation under § 831 of the Code. It files its federal income tax returns on a calendar-year basis. Taxpayer files statutory accounting financial statements with the State A insurance regulatory authorities.

A reciprocal is an organization or group of subscribers, including individuals, partnerships and corporations, who may insure each other by "exchanging" insurance contracts through their commonly appointed attorney-in-fact. All such insurance contracts are executed on behalf of all the subscribers by their designated attorney-in-fact. Taxpayer's commonly appointed attorney-in-fact is its wholly owned subsidiary, Attorney-in-Fact. Attorney-in-Fact is included in the consolidated federal income tax return filed by Taxpayer

Ownership of Taxpayer exists in the form of membership interests which may be owned solely by owners to whom and for whom a policy of insurance has been issued. In addition to insurance coverage, Taxpayer's members, as holders of liability insurance, acquire rights (a Membership Interest) in Taxpayer arising under its Subscription Agreements and Rules and Regulations, and otherwise. Among such rights are the right to vote, to share in Taxpayer's assets on liquidation, and, after qualifying as an insured for a certain number of continuous policy periods, to receive distributions when declared by Taxpayer's Board of Governors.

The Board of Governors can declare a distribution to members out of the surplus determined to be beyond that needed for continuing operating requirements and the protection of the members. The qualifications of members to receive dividends declared may be determined by the Board of Governors, except that a dividend may only be paid to a member who has been insured during four continuous policy periods. If Taxpayer is liquidated, any assets remaining after payment of all liabilities would be distributed to members in accordance with State A law.

Company is a State B corporation formed on Date D to be the publicly held holding company for Sub. Company is a wholly-owned subsidiary of Taxpayer. Sub, a wholly owned subsidiary of Company, is a State A stock insurance corporation organized to write Type G insurance in State B. Sub will have conducted no business prior to the Merger described below.

State A Statute provides that the surviving company in a merger of insurance companies shall be responsible and liable for all of the liabilities and obligations of each of the merged companies.

For what are presented to be valid business purposes, the following transaction (the "Merger") is proposed:

Taxpayer will be converted from a reciprocal to an State A stock insurance company. The conversion will be effected through a Plan and Agreement of Merger (the Merger Agreement) dated as of Date E, pursuant to which Taxpayer will be merged into Sub. Taxpayer represents that as part of the Merger, all of Taxpayer's membership interests will be extinguished, and every person who was a member of Taxpayer at the close of business on Date E ("Eligible Member") will receive common shares ("Common Shares") of stock of Company. Taxpayer further represents that out of a total of a Common Shares, b common shares will be allocated pro-rata among Eligible Members based on the ratio of each such Member's earned premiums to the total earned premiums of all Eligible Members from Date F through Date E. The remaining c Common Shares will be allocated evenly among Eligible Members. No fractional shares will be issued. Fractional shares will be rounded down or up to the nearest whole number of shares. Rounding may cause the aggregate number of shares issued to Eligible Members in the Merger to be slightly more or less than a.

Taxpayer also represents that pursuant to the Merger Agreement, the shares of Company held by Taxpayer will be canceled, and in consideration of such cancellation, Company will issue to Sub approximately d% of the Common Shares issued in the Merger. Taxpayer further represents that that d% of the Common shares will have the same aggregate value as the canceled shares Taxpayer held in Company before the Merger, determined immediately prior to Taxpayer's contribution to Company of its Sub stock.

After the Merger, Sub will operate the insurance business that Taxpayer had been operating immediately prior to the conversion. All insurance policies Taxpayer issued as well as Taxpayer's other obligations and liabilities will be assumed or succeeded to by Sub in the same manner as if incurred or contracted by Sub. Taxpayer's policyholders will not receive new policies from Sub; but they will receive an endorsement informing them that Sub is Taxpayer's successor. Upon their renewal, Sub will issue those policies.

Taxpayer represents that the business reason for the conversion is to enable Company to obtain increased financial and structural flexibility and to provide greater access to capital resources than are currently available to Taxpayer as a reciprocal, and thus to position it for long term growth. As an unincorporated association Taxpayer is unable to raise capital through the sale of equity securities. In contrast, Company, as a corporation, will be able to offer its shares as a means of raising capital.

The conversion, in addition to providing benefits to Taxpayer, will also provide benefits to its members. Presently, the membership interests in Taxpayer are not transferable. In contrast, Company' common stock will be freely tradable and will be listed on Stock Exchange. Additionally, as a result of the conversion, Eligible Members will become stockholders of Company.

The following representations have been made in connection with the proposed transaction:

1. Subject to ruling (1), below, the Merger will qualify under§ 368(a)(1)(A) and (a)(2)(D) of the Code and will be subject to the provisions of § 381 of the Code.

2. It is the intention of Company and Sub to join in the filing of a consolidated federal income tax return after the Merger.

3. The transaction will qualify under §§ 1.1502-75(d)(ii) and (iii) of the regulations.

4. There will be no reinsurance agreement between Taxpayer and Sub.

5. None of the consideration issued with respect to the Membership interests in the merger will be taken as a deduction in computing Taxpayer's taxable income under Subchapter L of the Code.

6. Taxpayer has no amount of savings credited to subscriber accounts within the meaning of § 832(f).

Section 381(a) of the Code provides that if a corporation acquires the assets of another corporation in a transfer to which § 361 (relating to nonrecognition of gain or loss to corporations) applies, the acquiring corporation succeeds to and takes into account, as of the close of the date of transfer, the items of the transferor corporation described in subsection 381(c), subject to the conditions and limitations specified in subsections (b) and (c) of § 381. This treatment is allowed only if the transfer is made in connection with a reorganization described in, inter alia, § 368(a)(1)(A).

Section 381(b) of the Code provides, in part, that, except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368(a)(1), the taxable year of the transferor corporation shall end on the date of transfer.

Section 381(c)(22) of the Code provides that if the acquiring corporation is an insurance company taxable under subchapter L, it must take into account those items of the transferor corporation required to be taken into account for purposes of subchapter L (to the extent proper to carry out the purposes of § 381(a) and of subchapter L, and under such regulations as may be prescribed by the Secretary). That Code section was amended in 1967 by P.L. 90-240, § 5(d) to apply to all insurance companies. Prior to that amendment, its predecessor applied only to life insurance companies. The regulations promulgated under that section have not been amended to reflect the change in the statute, and continue to refer only to life insurance companies.

Taxpayer and Company are nonlife insurance companies subject to tax under §§ 831 and 832, which are contained in subchapter L.

Section 832(a) provides that the taxable income of a nonlife insurance company is gross income defined in § 832(b)(1) less deductions allowed by § 832(b)(2). Gross income as defined in that section includes, among other items, the gross amount earned from underwriting income. Underwriting income is premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred. Section 832(b)(4) provides that the computation of premiums earned includes a comparison of the unearned premiums at the end of the preceding year with the unearned premiums at the end of the taxable year. Section 832(b)(5) provides that the computation of losses incurred includes a comparison of the discounted unpaid losses (as defined in § 846) outstanding at the end of the taxable year with the discounted unpaid losses outstanding at the end of the preceding taxable year. Section 832(b)(6) indicates that unpaid loss adjustment expenses shall be included in unpaid losses.

Section 832(f) provides, in part, that in the case of a mutual insurance company which is a reciprocal insurer there shall be allowed as a deduction the increase for the taxable year in savings credited to subscribe accounts, or there shall be included as an item of gross income the decrease for the taxable year in savings credited to subscriber accounts.[1]

Section 1.381(c)(22)-1(a) of the regulations requires the acquiring corporation to take into account the reserves described in former § 810(c) of the Code (now § 807(c)) transferred to it by the transferor corporation as of the close of the date of transfer in accordance with the provisions of § 381(c)(4) and the regulations thereunder. While no similar rule has been promulgated with respect to nonlife insurance companies subject to tax under § 831 et. seq., it is reasonable to apply a rule similar to the rule in regulation § 1.381(c)(22)-1(a) to Taxpayer's unpaid losses.

Section 846(a)(2)(C) provides that the amount of a taxpayer's discounted unpaid losses at the end of any taxable year attributable to any accident year shall be the present value of such losses (as of such time) determined, in part, by using the taxpayer's applicable loss payment pattern.

Sections 846(e)(1) and (2) provide that a taxpayer may elect to apply subsection (a)(2)(C) of that section by using a loss payment pattern determined by reference to certain of the taxpayer's own experience. The election is made separately for each determination year (1987 and every fifth calendar year thereafter) and applies to all of the taxpayer's eligible lines of business during the determination year.

Section 1.846-2(a) of the regulations provides that an insurer making the election must use its own historical loss payment pattern in discounting unpaid losses for each line of business that is an eligible line of business in the relevant determination year.

Section 1.1502-75(d)(1) of the regulations, provides, as a general rule, that an affiliated group will remain in existence only so long as the common parent corporation remains as the common parent, and at least one subsidiary remains affiliated with it.

Section 1.1502-75(d)(2)(ii) of the regulations creates an exception to the general rule of § 1.1502-75(d)(1) in the case of a transfer of the common parent's assets to a subsidiary. That exception provides that an affiliated group shall be considered as remaining in existence, notwithstanding that the common parent is no longer in existence, if the members of the affiliated group succeed to and become owners of substantially all of the assets of such former parent, and there remains one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation and which was a member of the group prior to the date such former parent ceases to exist.

Section 1.1502-75(d)(2)(iii) of the regulations provides, in part, that if a transfer of assets described in subsection (ii) of the subparagraph is an acquisition to which § 381(a) of the Code applies, and if the group files a consolidated return for the taxable year in which the acquisition occurs, then for purposes of § 381 the former common parent shall not close its taxable year merely because of the acquisition, and all taxable years of such former parent ending on or

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[1] Taxpayer has no amount of savings credited to subscriber accounts within the meaning of § 832(f).

before the date of acquisition shall be treated as taxable years of the acquiring corporation. Section 1.1502-75(d)(2)(iii) further provides that the corporation acquiring the assets shall close its taxable year as of the date of acquisition and all taxable years of such corporation ending on or before the date of acquisition shall be treated as taxable years of the transferor corporation.

The function of §§ 1.1502-75(d)(ii) and (iii) is to recognize the continuity of an affiliated group after a transaction that, even though formally restructuring the group, did not effect any substantial change in the composition of the group (judged by reference to the underlying assets of the group). It is implicit in the single economic entity theory underlying the consolidated regulations that the group ought to continue in existence after such a transaction.

Although the "taxpayer" for purposes of the election under § 846(e) is Company, which has no loss experience, it is consistent with the purpose of § 1.1502-75(d)(2)(ii) and (iii) to conclude that upon the completion of the Merger, the experience to be taken into account for purposes of determining Company's loss payment pattern is the experience of Taxpayer.

Based solely on the information submitted and the representations set forth above, it is held as follows:

(1) Provided the proposed merger otherwise qualifies as a reorganization under § 368(a)(1)(A) by reason of § 368(a)(2)(D) of the Code, the merger, as described above, will satisfy the continuity of interest requirement set forth in § 1.368-1(b) of the Regulations.

(2) Taxpayer will not be entitled to a deduction under § 832(b) for the transfer of assets to Sub in consideration for the assumption by Sub of liabilities under Taxpayer's insurance contracts.

(3) Sub will not take into premium income under § 832(b) any amount with respect to Taxpayer's assets transferred to Sub in connection with the Merger.

(4) Provided that the transaction qualifies under § 1.1502-75(d)(2)(ii) and is a transaction to which § 381(a) applies, then for purposes of § 381: (a) Taxpayer shall not close its taxable merely because of the acquisition, and all of Taxpayer's taxable years ending on or before the date of transfer shall be treated as taxable years of Sub; and (b) Sub shall close its taxable year as of the close of the date of transfer within the meaning of § 1.381(b)-1(b) of the regulations, and all taxable years of Sub ending on or before the date of transfer shall be treated as taxable years of the Taxpayer.

(5) Sub (i) will include in its estimate of unpaid losses as of the beginning of the taxable year in which the Merger takes place (i.e., as of the beginning of the calendar year in which the Merger takes place), Taxpayer's unpaid losses as of the end of the taxable year immediately preceding that taxable year, and, (ii) will include in its estimates of unpaid losses as of the end of that taxable year in which the Merger takes place, any unpaid losses of Taxpayer as of the end of that taxable year.

(6) For purposes of § 846(e), after the Merger, Sub will treat as its loss payment pattern, the historical loss payment pattern of Taxpayer immediately prior to the Merger.

No opinion is expressed about the tax treatment of the transaction under any other provisions of the Code and regulations of about the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above ruling. Specifically, no opinion has been requested and none is expressed about the tax treatment of the distribution of the c Common Shares as described above.

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) of the Code 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 of the taxpayers involved for the taxable year in which the transaction covered by this ruling letter is consummated.

Sincerely yours,
Assistant Chief Counsel (Corporate)

By:___________________________
Lewis K Brickates
Assistant to the Chief, Branch 2