**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
**WASHINGTON, D.C. 20224**

June 25, 2001

**OFFICE OF CHIEF COUNSEL**

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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR

FROM:

SUBJECT:

This memorandum constitutes Chief Counsel Advice. In accordance with § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Target =

Taxpayer =
State A =
Date A =
YEAR 1 =
YEAR 10 =
YEAR 11 =
z =

This memorandum is to inform you of a potential issue that may arise in the examination of Taxpayer for the 2000 taxable year in which it revoked its election under § 831(b).

Taxpayer is a small mutual insurance company incorporated in State A and is taxable under § 831. Taxpayer has been in the insurance business for many years and provides the property damage portion of fire and allied lines insurance coverage to residents in a limited geographic area within State A. Since YEAR 1, Taxpayer has elected under § 831(b) to be taxed only on its investment income (and not its underwriting income). On May 17, 2001, our office granted Taxpayer permission to revoke its election for the 2000 tax year.

Target was a small mutual insurance nonlife company which formerly provided the property damage portion of fire and allied lines coverage for many years within a limited geographic area within State A. Prior to Date A of YEAR 11 (when it merged

into Taxpayer), Target had not made a § 831(b) election, nor was it exempt from tax under § 501(c)(15). Rather Target reported both its underwriting and investment activities on the U.S. Property and Casualty Company Income Tax Return (Form 1120-PC and its predecessor forms). During YEAR 1 through YEAR 10 Target generated net operating losses totaling $z.

On Date A of YEAR 11, Target was acquired by Taxpayer in a statutory merger under State A law. After the merger, Taxpayer, the survivor, retained its election to be taxed only on its investment income (and not its underwriting income) under § 831(b). Now that the election has been revoked, Taxpayer may attempt to utilize the $x net operating loss carryforward from YEAR 1 through YEAR 10 of Target in Taxpayer's 2000 tax year. We have tentatively concluded this would be impermissible for the reasons set forth below.

As a matter of background, we assume that the statutory merger was a reorganization within the meaning of § 368(a)(1)(A) and, pursuant to the usual rules applicable to net operating loss carryovers in reorganizations, under § 381(c)(1)(A), the net operating losses (of Target as the transferor corporation), determined under § 172, would (subject to certain conditions and limitations) carryover from such transferor corporation to the acquiring corporation in the first taxable year after the date of transfer. Section 172 allows a deduction for the taxable year of an amount equal to the aggregate of (1) the net operating loss carryover to such year, plus (2) the net operating loss carrybacks to such year. Section 172(b)(1)(A)(ii), generally, provides that a net operating loss for any taxable year shall be a net operating loss carryover to each of the 20 years following the taxable year of the loss.

Section 831(a) provides that taxes computed as provided in § 11 shall be imposed for each taxable year on the taxable income of every insurance company other than a life insurance company.

Section 831(b) provides that in lieu of the tax otherwise applicable under § 831(a), there is imposed for each taxable year on the income of every insurance company to which this subsection applies a tax computed by multiplying the taxable investment income of such company for such taxable year by the rates provided in § 11(b).

Section 831(b)(2) provides, in part, that § 831(b) applies to every insurance company other than life (including interinsurers and reciprocal underwriters) if -

> (i) the net written premiums (or if greater, direct written premium) for the taxable year exceed $250,000 but do not exceed $1,200,000, and
>
> (ii) such company elects the application of this subsection for such taxable year.

Section 831(b)(3) provides that for purposes of this part, except as provided in § 844,[1] a net operating loss (as defined in § 172) shall not be carried - (A) to or from any taxable year for which the insurance company is not subject to the tax imposed by subsection (a), or (B) to any taxable year if, between the taxable year from which the loss is being carried and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by subsection (a). (underlying supplied.)

Target's merger into Taxpayer, through the operation of the carryover provisions of § 381(c)(1)(A), resulted in Taxpayer's acquisition of a net operating loss during a year (YEAR 11) in which Taxpayer was subject to § 831(b). As set forth above, § 831(b)(3)(A) provides that a net operating loss shall not be carried from any tax year in which a nonlife insurance company is not subject to the tax imposed by § 831(a). Accordingly, § 831(b)(2)(A) bars a net operating loss from being carried forward from a § 831(b) electing year (e.g., YEAR 11) (in which Taxpayer is not taxed on its underwriting income) to a § 831(a) tax year (e.g., 2000 or following years) in which it is fully taxable under part II of subchapter L. Accordingly, we tentatively conclude it would be impermissible to utilize Target's net operating losses for the year 2000 or any year thereafter.

Please call William Sullivan at (202) 622-3970 if you have any further questions.

Acting Associate Chief Counsel
(Financial Institutions & Products)
By:MARK SMITH
Chief, CC:FIP:4

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[1] Section 844(a) provides that if an insurance company - (1) is subject to the tax imposed by part I or II of this subchapter for the taxable year, and (2) was subject to the tax imposed by a different part of this subchapter for a prior taxable year, then any operations loss carryover under section 810 (or the corresponding provisions of prior law) or net operating loss carryover under 172 (as the case may be) arising in such prior taxable year shall be included in its operations loss deduction under section 810(a) or net operating loss deduction section 832(c)(10) as the case may be. No exception from the rule of section 831(b)(3)(A) results from the operation of section 844 in the present case because this provision only applies to insurance companies changing between part I and part II of subchapter L (and the reverse).