Internal Revenue Service

Number: **200951004**
Release Date: 12/18/2009

Index Number: 381.04-03, 381.05-04, 381.21-02, 832.06-02

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:FIP:B04
PLR-115007-09
Date:
September 10, 2009

Parent

Target

Acquiring Corporation

Country X

State Y

State Z

Date 1

Date 2

Dear :

This is in response to your request dated January 30, 2009 and additional submissions, filed by Parent (Taxpayer) on behalf of Acquiring Corporation, its wholly-owned subsidiary, which involve a ruling request arising in a statutory merger represented to be a reorganization within the meaning of section 368(a)(1) of the Internal Revenue Code. Specifically, a ruling was requested under section 1.381(c)(4)-1(d) of the Income Tax Regulations regarding the appropriate method of accounting for unpaid losses for the surviving corporation.

FACTS

Taxpayer represents, that as part of a section 368(a)(1) merger, Target changed its place of incorporation from Country X to State Y on Date 1. Immediately thereafter, Target was transferred to Acquiring Corporation. On Date 1, Target transferred all of its assets and liabilities to Acquiring Corporation, other than certain assets and liabilities relating to certain reinsurance contracts. As part of that same plan, immediately upon receipt of the requisite regulatory approval, on Date 2, Target merged into Acquiring Corporation in a statutory merger. Taxpayer represents that, together, the Date 1 transfer of Target's assets and Date 2 merger of Target into Acquiring Corporation constituted a reorganization described in section 368(a)(1)(D).

Taxpayer represents that Acquiring Corporation is a property/casualty insurance company domiciled in State Z and subject to tax under section 831. Its primary business involves providing credit enhancement and protection through the issuance of financial guaranty insurance, as well as the reinsurance of financial guaranty insurance.

Acquiring Corporation has established loss reserves and deducted unpaid losses for tax purposes to cover anticipated future claims in situations where an event of default or claim has not yet occurred under the applicable insurance policy. Acquiring Corporation requests permission to deduct its unpaid losses only when an event of default occurs or a claim is made. Acquiring Corporation represents that it will deduct its loss reserves as permitted under section 832(b) and discounted as required by section 846.

Taxpayer represents that Target has never had effectively connected income in the United States and that it has never filed a U.S. Corporate Income Tax return. Taxpayer further represents that the method of accounting of Target for unpaid losses is not readily discernible, and that the method of accounting of Acquiring Corporation is not a correct method of accounting. Taxpayer states that it has no evidence that Target is using the same method of accounting for unpaid losses as Acquiring Corporation and that, for purposes of section 381, Target and Acquiring Corporation are using different methods of accounting.

LAW AND ANALYSIS

Section 381(a) of the Code provides that if a corporation acquires the assets of another corporation in a transfer to which section 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 section 381(c), subject to the conditions and limitations specified in sections 381(b) and (c). This treatment is allowed if the transfer is made in connection with a reorganization described in, inter alia, section 368(a)(1)(D).

Section 381(c)(4) provides that the acquiring corporation shall use the method of accounting used by the distributor corporation on the date of distribution unless different methods were used by several distributor corporations or by a distributor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of computing taxable income adopted pursuant to regulations prescribed by the Secretary.

Section 1.381(c)(4)-1(a)(1)(i) of the Income Tax Regulations provides that "[i]f different methods of accounting were used, the acquiring corporation shall use the method or combination of methods of accounting adopted pursuant to this section."

Treas. Reg. section 1.381(c)(4)-1(b)(3)(ii) provides that to the extent that different methods of accounting were employed on the date of transfer by the parties to a transaction described in section 381(a) of the Code with respect to any trades or businesses which are integrated or required to be integrated in accordance with section 446(d) and the regulations thereunder, the acquiring corporation is to adopt the principal method of accounting determined under section 1.381(c)(4)-1(c) of the regulations, or the method of accounting determined in accordance with section 1.381(c)(4)-1(d), whichever is applicable.

Treas. Reg. section 1.381(c)(4)-1(c)(1) provides that the acquiring corporation is to use the principal method of accounting (as determined under section 1.381(c)(4)-1(c)(2)), provided that such method of accounting clearly reflects the income of the acquiring corporation. The increase or decrease in tax resulting from the change from the method of accounting previously used by any of the corporations involved is to be taken into account by the acquiring corporation. The adjustments necessary to reflect such change and such increase and decrease are determined and computed in the same manner as if, on the date of transfer, each of the several corporations whose method or methods of accounting are required to be changed in accordance with this section, had initiated a change in accounting method. Paragraph (c) also provides rules for determining the principal method of accounting.

Treas. Reg. section 1.381(c)(4)-1(d)(1)(i) provides that "[i]f the acquiring corporation may not continue to use…the method of accounting used by it or the distributor or transferor corporation or corporations on the date of distribution or transfer, and may not under paragraph (c) use the principal method of accounting, or, if there is no principal method of accounting, then the Commissioner shall determine the appropriate method or combination of methods of accounting to be used."

Taxpayer represents that Acquired Corporation and Target were using different methods of accounting for unpaid losses as of the date of distribution or transfer. Pursuant to Treas. Reg. section 1.381(c)(4)-1(b)(3)(ii), the provisions of Treas. Reg. section 1.381(c)(4)-1(c) must be applied to determine whether the Acquiring Corporation should adopt the "principal method of accounting." The Taxpayer also represents that Target would be the larger company for purposes of the tests set forth in the regulations.

Property and casualty insurers must include in gross income the amount of their underwriting income as provided in section 832(b), computed on the basis of the underwriting and investment exhibit of the NAIC annual statement. Section 832(b)(1)(A). Section 832(b)(3) defines the term "underwriting income" as the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred. With respect to the term "losses incurred," section 832(b)(5) provides that a property and casualty insurance company is entitled to reduce gross income for the taxable year to the extent that its estimated unpaid losses exceed its estimated unpaid losses for the previous taxable year. Conversely, section 832(b)(5) provides that a property and casualty insurance company must increase gross income for the taxable year to the extent that its estimated unpaid losses are less than its estimated unpaid losses with respect to the previous taxable year.

The deduction for unpaid losses is not subject to cash or accrual accounting rules. See United States v. General Dynamics Corp., 481 U.S. 239, 246-247 (1987). Rather, unpaid losses are an estimate, made at the close of the taxable year, of the insurer's liability for claims that it will be required to pay in future years. Western Cas. & Sur. Co. v. Commissioner, 65 T.C. 897, 917 (1976), aff'd., 571 F.2d 514 (10th Cir. 1978). In estimating its unpaid losses, an insurance company must comply with Treas. Reg. section 1.832-4(b), which provides that:

> Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses. . . These losses must be stated in amounts which, based upon the facts in each case and the company's experience with similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay.

Because Target’s method of accounting cannot be determined, and because the Acquiring Corporation’s method of accounting for unpaid losses is not a correct method of accounting, pursuant to Treas. Reg. section 1.381(c)(4)-1(d)(1)(i), permission is hereby granted to Acquiring Corporation to account for its unpaid losses in accordance with the requirements of sections 832 and 846, and Treas. Reg. section 1.832-4(b).

Treas. Reg. section 1.381(c)(4)-1(d)(1)(iii) provides that “[t]he adjustments necessary to reflect such change and such increase or decrease in tax shall be determined and computed in the same manner as if, on the date of distribution or transfer, each of the several corporations that were not using the method or combination of methods of accounting adopted pursuant to subdivision (i) or (ii) of this subparagraph had initiated a change in accounting method.”

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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.

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

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. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

/S/

Sheryl B. Flum
Chief, Branch 4
(Financial Institutions & Products)