INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

August 05, 2005

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200549007**
Release Date: 12/9/2005

Index (UIL) No.: 382.00-00, 816.01-00, 1502.19-00, 1502.80-00, 1503.05-00
CASE-MIS No.: TAM-119882-05

Director
Field Operations
Natural Resources & Construction
Field Operations West

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Corp. A =

Corp. B =

Corp. C =

Corp. D =

Business A =

Year A =

Year B =

Year C =

Month A =

Month B =

Date A =

Date B =

Date C =

Date D =

Date E =

Date F =

Date G =

Date H =

Date I =

State A =

$a =

$b =

$c =

$d =

$e =

$f =

$g =

$h =

$i =

$j =

$k =

$l =

n =

o =

q =

r =

s =

u =

v =

ISSUE(S):

1. When is Corp. B's loss on the worthlessness of the Corp. C stock treated as occurring?

2. Is the use of the worthless securities loss limited by either § 1503(c)(1) or § 382 of the Internal Revenue Code?

CONCLUSION(S):

1. Corp. B's loss on the worthlessness of the Corp. C stock is treated as occurring between Date G and Date H, inclusive.

2. The worthless securities loss is limited by § 1503(c)(1) but not by § 382.

FACTS:

Corp. A is the common parent of an affiliated group (the "Corp. A group") that has filed consolidated Federal life/nonlife income tax returns since Year A. An election under § 1504(c)(2) continues in effect. The Corp. A group's taxable year is the calendar year. The Corp. A group conducts an insurance business. Its insurance subsidiaries develop, market, and administer individual life insurance, supplemental health insurance, annuity, and other insurance products.

On Date A, members of the Corp. A group acquired Corp. C. The Corp. A group thereafter operated Business A through Corp. C and Corp. C's subsidiaries. Corp. A owned all the outstanding preferred stock in Corp. C.

Corp. B was a member of the Corp. A group and a holding company with no employees of its own and virtually no tangible property. Corp. B owned all the outstanding common stock in certain subsidiaries, including Corp. C (following the Corp. A group's acquisition of Corp. C) and Corp. D. Corp. D first participated in the Corp. A group consolidated life/nonlife income tax returns as an eligible life insurance company in Year B.

On Date B, each of Corp. A, Corp. B, and Corp. C, along with certain other Corp. A group subsidiaries, filed voluntary petitions under chapter 11 of title 11 of the United States Code ("Chapter 11") in bankruptcy court (the "Bankruptcy Court"). Their cases were jointly administered.

As noted later below, the taxpayer and the Service have agreed that all the stock in Corp. C became worthless, for purposes of § 165(g), during Year C.

In Month B of Year C, pursuant to an auction conducted four months earlier in Month A of Year C, Corp. C sold (with Bankruptcy Court approval approximately three months prior to such sale) virtually all its assets to unrelated parties for cash and the assumption of liabilities. Within the next several months, Corp. C used approximately n percent of such cash proceeds to pay off some of its debts. During the same period of several months, Corp. C's activities included attempting to resolve as many remaining liabilities and collect as many assets as possible. Between Month B of Year C and Date G, activities of Corp. C included "generally winding down" Business A.

On Date C, the Bankruptcy Court entered an order confirming a liquidating plan of reorganization pursuant to Chapter 11 for Corp. C (the "Corp. C Plan"). The idea of liquidation had been formed prior to Date C, apparently by Month B of Year C at the latest. The effective date of the Corp. C Plan was Date G. Pursuant to the Corp. C Plan, as of its effective date, all of Corp. C's remaining assets were transferred to a post-consummation estate, and the equity interests in Corp. C were canceled.

Also on Date C, the Bankruptcy Court entered an order confirming a plan of reorganization pursuant to Chapter 11 for Corp. A and Corp. B (the "Corp. A/B Plan"). The effective date of the Corp. A/B Plan was Date D. As a result of the bankruptcy reorganization provided for by the Corp. A/B Plan, the Corp. A group, including Corp. B, underwent a § 382 ownership change on Date D, the effective date of the Corp. A/B Plan. Corp. A made a timely election under § 1.382-6(b) of the Income Tax Regulations to allocate the group's income and losses for Year C under the closing-of-the-books method.

On Date E, Corp. D, which was solvent, merged with and into Corp. B. According to Best's Insurance Reports, in Year C Corp. D had $a of net premiums written, $b of

direct premiums written, $c of net investment income, $d of net income, $e of assets, and $f of net policy reserves. As a result of and subsequent to the merger, Corp. B operated, for state law purposes, as a life insurance company under the rules and regulations of the State A Department of Insurance. For the period Date F through Date H, Corp. B had $g of premium income from the sale of life insurance, $h of dividend income from life insurance subsidiaries, and $i of other gross income.

On Date I, the taxpayer and the Service entered into a Closing Agreement, with the parties agreeing that:

1. The Corp. C preferred stock held by Corp. A became a worthless security during the taxable year ended Date H, for purposes of § 165(g).

2. The Corp. C common stock held by Corp. B became a worthless security during the taxable year ended Date H, for purposes of § 165(g).

3. The loss on the worthlessness of the Corp. C preferred and common stock was treated as an ordinary loss pursuant to § 165(g)(3).

4. The loss on the worthlessness of the Corp. C preferred stock was $j and the loss on the worthlessness of the Corp. C common stock was $k.

The agreement did not address when in Year C the Corp. C stock became worthless or whether the worthless security loss incurred by Corp. B is fully available to offset the taxable income of the Corp. A group or whether § 382 limits the use of the loss.

LAW:

Section 1503(c)(1) provides, in part:

> If an election under section 1504(c)(2) is in effect for the taxable year and the consolidated taxable income of the members of the group not taxed under section 801 results in a consolidated net operating loss for such taxable year, then under regulations prescribed by the Secretary, the amount of such loss which cannot be absorbed in the applicable carryback periods against the taxable income of such members not taxed under section 801 shall be taken into account in determining the consolidated taxable income of the affiliated group for such taxable year to the extent of 35 percent of such loss or 35 percent of the taxable income of the members taxed under section 801, whichever is less.

Section 1.1502-80(c) provides, in part:

> Deferral of section 165. For consolidated return years beginning on or after January 1, 1995, stock of a member is not treated as worthless under section

165 before the stock is treated as disposed of under the principles of §1.1502-19(c)(1)(iii).

Section 1.1502-19(c)(1)(iii) provides, in part:

> Disposition of stock. For purposes of this section:
>
> (1) In general.--P is treated as disposing of a share of S's stock
>
> . . .
>
> (iii) Worthlessness.--At the time--
>
> (A) Substantially all of S's assets are treated as disposed of, abandoned, or destroyed for Federal income tax purposes (e.g., under section 165(a) or §1.1502-80(c) . . .). An asset of S is not considered to be disposed of or abandoned to the extent the disposition is in complete liquidation of S or is in exchange for consideration (other than relief from indebtedness);
>
> . . . .

Section 1.1502-19(e) provides an anti-avoidance rule:

> If any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section.

Section 1.1502-19(g), Example 6, is an illustration of the application of the anti-avoidance rule.

> Example 6. Avoiding worthlessness. (a) Facts. P forms S with a $100 contribution and S borrows $150. For Years 1 through 5, S has a $210 ordinary loss that is absorbed by the group. Under §1.1502-32(b), S's loss results in P's having a $110 excess loss account in S's stock. S defaults on the indebtedness, but the creditor does not discharge the debt (or initiate collection procedures). At the beginning of Year 6, S ceases any substantial operations with respect to the assets, but maintains their ownership with a principal purpose to avoid P's taking into account its excess loss account in S's stock.
>
> (b) Analysis. Under paragraph (c)(1)(iii)(A) of this section, P's excess loss account ordinarily is taken into account at the time substantially all of S's assets are treated as disposed of, abandoned, or destroyed for Federal income tax purposes. Under paragraph (e) of this section, however, S's assets are not taken

> into account at the beginning of Year 6 for purposes of applying paragraph (c)(1)(iii)(A) of this section. Consequently, S is treated as worthless at the beginning of Year 6, and P's $110 excess loss account is taken into account.

Section 1.382-6(b)(1) provides, in part:

> Subject to paragraphs (b)(3)(ii) and (d) of this section, a loss corporation may elect to allocate its net operating loss or taxable income and its net capital loss or modified capital gain net income for the change year between the pre-change period and the post-change period as if the loss corporation's books were closed on the change date.

ANALYSIS:

ISSUE 1

Section 1.1502-80(c) and that section's cross-reference to § 1.1502-19(c)(1)(iii) operate in certain circumstances to defer a worthless securities loss on stock beyond the point in time at which such loss would otherwise be recognized under § 165. In Month B of Year C, Corp. C sold virtually all of its assets primarily for cash. Because in this transaction Corp. C received consideration other than relief from indebtedness, § 1.1502-19(c)(1)(iii)(A) does not operate to treat Corp. B as having disposed of its Corp. C stock at that time. Within several months after the sale of assets in Month B of Year C, Corp. C used approximately n percent of the cash proceeds to pay off some of its debts. Because Corp. C retained approximately o percent of its assets (100 minus n), more than an insubstantial part of its assets, § 1.1502-19(c)(1)(iii)(A) does not operate to treat Corp. B as having disposed of its Corp. C stock at that time, either.

Thus, § 1.1502-19(c)(1)(iii)(A) operates to treat Corp. B as having disposed of its Corp. C stock no earlier than Date G, the Corp. C Plan's effective date at which time Corp. C transferred all its remaining assets to a post-consummation estate and the equity interests in Corp. C were canceled. The taxpayer and the Service agreed in the Closing Agreement that the Corp. C stock became a worthless security for purposes of § 165(g) during the taxable year ended Date H. Therefore, the Corp. C stock became a worthless security for purposes of § 165(g) sometime between Date G and Date H, inclusive.

Despite Corp. C's retention of approximately o percent of the cash from the sale of substantially all of its assets, the examining agent argues that the anti-avoidance rule of § 1.1502-19(e) should apply to treat Corp. C as worthless prior to Date G. While the facts of this case appear similar to the facts of § 1.1502-19(g), Example 6, in which a corporation was treated as worthless for purposes of applying § 1.1502-19(c)(1)(iii)(A) despite retaining more than an insubstantial part of its assets, the anti-avoidance rule of § 1.1502-19(e) does not apply here. The anti-avoidance rule applies only if a person

acts with a principal purpose to avoid the effect of the rules of § 1.1502-19 or to avoid the effect of another provision of the consolidated return regulations.

It is clear that the drafters of §§ 1.1502-19(c)(1)(iii)(A) and 1.1502-80(c) not only contemplated that § 1.1502-80(c) could operate to defer worthlessness under circumstances of bankruptcy, but intended such a result. The preamble to the proposed regulations under §§ 1.1502-19 and 1.1502-80(c) provides two reasons why the deferral of worthlessness is necessary. The first reason provided is inapplicable to the facts of this case. The second reason, however, goes right to the heart of the issue. As stated in the preamble:

> [R]ecent bankruptcy cases indicate a judicial tendency to protect a bankrupt subsidiary's tax attributes. For example, because section 382(g)(4)(D) may subject [a subsidiary's] losses to a zero section 382 limitation if [a parent corporation] treats [a subsidiary's] stock as worthless, the courts may prevent [a subsidiary's] stock from being treated as worthless. See, e.g., In re Prudential Lines, Inc., 928 F.2d 565 (2d Cir. 1991), cert. denied, [502 U.S. 821 (1991)]. . . .
>
> . . . .
>
> . . . By deferring the treatment of [a subsidiary's] stock as worthless, tension is alleviated with respect to the cases protecting the attributes of bankrupt subsidiaries.

1992-2 C.B. 627, 637.

The taxpayer has not acted with a principal purpose to avoid the effect of §§ 1.1502-19(c)(1)(iii)(A) or 1.1502-80(c) and the anti-avoidance rule of § 1.1502-19(e) does not apply on the facts of this case. Accordingly, the Corp. C stock is treated as worthless no earlier than Date G. This result obtains notwithstanding that Corp. C may months prior to Date G have been hopelessly insolvent, no longer conducting its historic trade or business, and effectively under the control of its creditors and the Bankruptcy Court.

ISSUE 2

The 35 percent limitations found in § 1503(c)(1) can apply if the consolidated taxable income of the members of the group not taxed under § 801 results in a consolidated net operating loss for the group for the taxable year. As a § 165 worthless securities loss was incurred by Corp. B, it is necessary to determine whether Corp. B was or was not taxed under § 801 at the time the worthless securities loss was properly recognized.

Under § 816(a), the term "life insurance company" means an insurance company that is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with accident and health insurance), or noncancellable

contracts of health and accident insurance, if (1) its life insurance reserves, plus (2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, accident, or health policies not included in life insurance reserves, comprise more than fifty percent of its total reserves. The term "insurance company" means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

Because the definition of a life insurance company looks to the activities of the company for the entire taxable year, a company will be characterized for that year as a life insurance company on the basis of its activities for the entire year. H.R. Rep. No. 98-432, pt. 2, at 1402 (1984). Thus, if more than half a company's business activity during the taxable year is the issuing of insurance and annuity contracts or the reinsuring of risks underwritten by insurance companies, and if more than fifty percent of its total reserves for the taxable year are life insurance reserves or unearned premiums and unpaid losses on noncancellable life, accident, or health policies, then the company would be taxable as a life insurance company for such taxable year. Id.

While a taxpayer's name, charter powers, and state regulation help to indicate the activities in which it may properly engage, whether the taxpayer qualifies as an insurance company for Federal income tax purposes depends on its actual activities during the year. Inter-American Life Ins. Co. v. Commissioner, 56 T.C. 497, 506-08 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1972) (taxpayer whose predominant source of income was from investments did not qualify as an insurance company); see also Bowers v. Lawyers Mortgage Co., 285 US 182, 188 (1932). To qualify as an insurance company, a taxpayer "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance." Indus. Life Ins. Co. v. United States, 344 F.Supp. 870, 877 (D. S.C. 1972), aff'd per curiam, 481 F.2d 609 (4th Cir. 1973). All of the relevant facts will be considered, including but not limited to, the size and activities of any staff, whether the company engages in other trades or businesses, and its sources of income. See generally, United States v. Home Title Ins. Co., 285 US 191, 195 (1932) (where insurance and charges incident thereto were more than 75 percent of company's income, "[u]ndeniably insurance [was] its principal business"); Lawyers Mortgage Co., at 188-90; Indus. Life Ins. Co., at 875-77; Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387, 391-92 (N.D. Tex. 1969), rev'd on other grounds, 425 F.2d 1328 (5th Cir. 1970); Serv. Life Ins. Co. v. United States, 189 F. Supp. 282, 285-86 (D. Neb. 1960), aff'd on other grounds, 293 F.2d 72 (8th Cir. 1961); Inter-American Life Ins. Co., at 506-08; Nat'l Capital Ins. Co. of the Dist. of Columbia v. Commissioner, 28 B.T.A. 1079, 1085-86 (1933).

Cardinal Life involved a company chartered to write life, health, and accident coverage. During two of the five years at issue, Cardinal Life did not issue insurance contracts or reinsure risks underwritten by insurance companies, it had no premium income, and no reserves. For the remaining three years, Cardinal Life reinsured risks underwritten by an insurance company; its premium income was less than one percent of its income for

two of those years and approximately nine percent in the third. Its reserves were minimal. Meanwhile, Cardinal Life had income from dividends and interest, leasing real estate and trailers, and capital gains. The court held that Cardinal Life was not an insurance company for any of the years at issue because its capital and efforts were devoted primarily to its investment activity; it did not solicit insurance business and derived insignificant amounts of income from what insurance business it transacted while deriving substantial income from its investments.

In contrast, the taxpayer in Serv. Life was held to be an insurance company. During the years at issue, Service Life issued life, health, and accident policies, and also solicited and arranged mortgage loans with money borrowed from the Federal Home Loan Bank. Between 35,000 and 70,000 policies were in force during the years at issue, representing life coverage of over $22,000,000. At the same time, only about 1,800 mortgages were outstanding. Service Life's premium income accounted for between 57 percent and 79 percent of its total income. Under these facts, the character of the business actually done by Service Life during the years at issue was insurance, and thus it was an insurance company.

An entity is or is not an insurance company for a taxable year on the basis of its activities for the entire year. Thus, an entity cannot be an insurance company for only a part of its taxable year.

It is questionable whether Corp. D was an insurance company in Year C. According to Best's Insurance Reports, in Year C, less than q percent of Corp. D's net income during the taxable year was from premium income ($a net premiums written / $d net income). Corp. D's relative amount of premium income to its other income was less than the relative amount of premium income (up to approximately nine percent) earned by the company at issue in Cardinal Life during years in which it was held not to be an insurance company and far less than the relative amount of premium income (between 57 percent and 79 percent) earned by the company at issue in Serv. Life during years in which it was held to be an insurance company. If Corp. D was not an insurance company in Year C, then its merger into Corp. B in Year C would not have affected Corp. B's status as a non-insurance company at the time of the merger.

Even if Corp. D was an insurance company prior to its merger into Corp. B, Corp. B was not an insurance company for its taxable year ending Date H. For over r percent of the taxable year, Corp. B had no employees and virtually no tangible property. Its only activities were as a holding company. For less than s percent of the taxable year, Corp. B engaged in some insurance business. However, for the period in which Corp. B engaged in some insurance business, only u percent of Corp. B's income was from premium income ($g premium income / $l total gross income). In addition, Corp. B probably had significant income generated from its subsidiaries in Year C prior to its merger with Corp. D (the amount of such income, if any, is not known by us at this time). The presence of such income would mean that Corp. B's relative amount of premium income to its other income during its entire taxable Year C would be even less

than u percent ($g premium income / ($l + any income generated from its subsidiaries in Year C prior to the merger)). Even if one were to assume that Corp. B had no income in Year C prior to the merger, Corp. B's relative amount of premium income to its other income in Year C was less than the relative amount of premium income (up to approximately nine percent) earned by the company at issue in Cardinal Life during years in which it was held not to be an insurance company and far less than the relative amount of premium income (between 57 percent and 79 percent) earned by the company at issue in Serv. Life during years in which it was held to be an insurance company.

Accordingly, under either of the above analyses, Corp. B was not an insurance company on any day of its taxable year Year C. Therefore, Corp. B's § 165 loss is for purposes of § 1503(c)(1) included in the consolidated taxable income of the members of the group not taxed under § 801.

The issue also was posed whether § 382 applies to limit the losses on the Corp. C stock. The taxpayer made a closing-of-the-books election under § 1.382-6(b) for the ownership change that took place on Date D. Since the worthlessness of the Corp. C stock arose no earlier than Date G, and since there are no special rules under § 1.382-6 with respect to the allocation of extraordinary items (see T.D. 8546, 1994-2 C.B. 43, 44), the worthless securities loss is limited under § 382 only if the Corp. A group has a net unrealized built-in loss (NUBIL). Under § 1.1502-91(g), whether a consolidated group has a NUBIL is determined by looking at the assets of each member of the group. However, the stock of any subsidiary in the group is not taken into account if one of four situations described in § 1.1502-91(g)(2)(ii) exists. One of those situations is that the common parent and the subsidiary have been affiliated for at least five consecutive years. The Corp. A group acquired Corp. C on Date A. The Date D, Corp. A ownership change occurred more than five years after the acquisition. That the § 165 loss may economically have accrued prior to Date D, is not relevant, as economic accrual is a consideration displaced by the special rules for built-in gains and losses found in § 382(h). Consequently, any built-in loss in the stock of Corp. C is not taken into account in determining whether the Corp. A group had an overall NUBIL. In addition, Corp. C did not have a built-in loss in its own assets at the ownership change date, because, as noted earlier, it had sold virtually all of its non-cash assets for cash and assumption of liabilities v months earlier, in Month B of Year C.

The taxpayer has provided facts indicating that absent treating the stock of Corp. C as a built-in loss asset, the Corp. A group would not have a NUBIL within the meaning of § 382(h)(3), and the examining agent has not provided any facts to refute the taxpayer's position. Accordingly, § 382 does not limit the use of the worthless securities loss on the stock of Corp. C against future income of the Corp. A group.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.