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Internal Revenue Service

Department of the Treasury

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CC:DOM:IT&A:5 PLR-100274-99

Date: JAN 5 2000

Fcorp =
Gcorp =
Branch =
Acorp =
Bcorp =
Ccorp =
Holding =
Year 1 =
Year 2 =
Year3 =
Year4 =
Date 1 =
State L =
State M =
State N =
Country W =
Country X =
City Y =
City Z =

Dear

This responds to your letter of May 15, 1998, and supplemental correspondence, requesting rulings as to federal income tax consequences of certain aspects of the domestic incorporation of Branch. This ruling supplements a ruling dated December

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31, 1998, (PLR-111358-98, PLR 199914012) issued by the Corporate division of the Office of Associate Chief Counsel (Domestic). This office is asked to rule that the entities which have succeeded to the assets and liabilities of Branch may deduct certain expenses that would otherwise be the expenses of Branch, including state and local taxes, interest, business expenses and expenses incurred in connection with "deferred benefit arrangements." Also referred to this office is a request for a ruling that participants in the "deferred benefit arrangements" are not currently taxable, under either a constructive receipt or economic benefit theory, as a result of the assumption of those liabilities by the successor entities of Branch.

FACTS

Fcorp is a corporation organized under the laws of Country X in Year 1 to carry on an insurance business. Since Year 2. its principal offices have been located at City Y, Country X. Shares of Fcorp are publicly traded on the Country X exchange. Fcorp conducts a substantial property-casualty insurance business both in Country X and in other countries through branches. It also serves as the parent of a large business conglomerate consisting of property-casualty insurance, life insurance, reinsurance and asset management companies.

Fcorp conducted its property-casualty insurance business in the United States through a branch operation known as Branch. One successor entity of Branch is Acorp. The transaction, for which this letter ruling is sought, primarily involves Fcorp's transfer of Branch's assets and liabilities to a domestic entity, Acorp, a corporation formed under the laws of State M. Fcorp also transferred Branch's United States real property to a second newly formed corporation, Bcorp, a United States real property holding company. The transfers occurred on Date 1, Year 4.

Branch's principal offices were located at City Z, State L. Branch was licensed to sell property-casualty insurance in State M in Year 3 and was subsequently licensed to sell property-casualty insurance in all 50 states, Washington, D.C., Puerto Rico, and the U.S. Virgin Islands. Branch's assets, liabilities and operations were reported on a standard NAIC Annual Statement, in substantially the same manner as domestic property-casualty insurance companies. Branch filed Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return, on a calendar year basis. Branch kept its books and filed its U.S. tax returns on a statutory accounting basis, consistent with its method of reporting on its NAIC Annual Statement.

Branch had certain liabilities other than those directly related to the payment of claims. First, Branch had obligations under unfunded, non-qualified deferred compensation agreements and unfunded non-qualified [illegible] arrangements for certain current and former employees, including one "Rabbi Trust." Second, Branch had contingent liabilities for certain federal, state and local income taxes and for interest on such taxes ("tax liabilities"). Third, Branch had non-contractual liabilities, other than the "tax liabilities," that were contingent and non-contingent (the "other liabilities"). None of these three categories of liabilities were payable by Branch before the transaction.

Branch owned office buildings in City Z (the Real Property). The Real Property, although partially leased to third parties, was Branch's primary location in the United States. The Real Property was unencumbered, was essential to Branch's insurance operations. and represented a material portion of the Branch's assets supporting its insurance liabilities and statutory surplus.

Fcorp owned directly or indirectly all the stock of Holding. Holding is itself the parent of a U.S. consolidated group. Through its subsidiaries, Holding is engaged in the businesses of providing property-casualty insurance, life insurance and financial services, although not itself a licensed insurer. Holding is a State N corporation, with two classes of stock outstanding, common and preferred. All of the common is held directly by Fcorp. All of the preferred stock was held by Branch as an admitted asset for regulatory purposes. Holding's corporate offices are located at City Z, State L.

Holding formed Acorp and contributed to it cash for stock. Holding also transferred to Acorp all of the common stock of one of its several subsidiaries, Ccorp. and Fcorp contributed to the capital of Holding the 100 percent interest in the preferred stock of Holding held by Branch. Upon obtaining required regulatory approvals, Fcorp transferred all assets held by Branch at that time (Branch Assets), except the Real Property, to Acorp in exchange for Acorp's assumption of all of Branch's liabilities (Branch Liabilities). Holding also issued additional shares of stock to Fcorp even though the transfer of Branch Assets was directly to Acorp.

The transfer of Branch Assets to, and assumption of Branch Liabilities by, Acorp constituted a "domestication" of Fcorp's business in the United States, Pursuant to State M law, Fcorp and Acorp entered into the "domestication agreement" which provided for the transfer of Branch Assets and assumption of Branch Liabilities. Domestication became effective upon the filing of the "instrument cf transfer and assumption" with the State M Superintendent of Insurance. This occurred in Year 4.

With respect to the same transaction, and the same related parties named in these facts, the Service has previously ruled:

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(A) No gain or loss will be recognized by [Fcorp] by reason of its transfer of [the preferred stock of Holding and Branch's assets] and the assumption of [Branch's] liabilities (§§ 351(a) and 357(a)):

(B) [Holding] shall not recognize gain or loss upon the constructive (if any) or actual receipt of [Branch's assets or its own preferred stock from Fcorpl (§ 1032(a));

(C) [Holding] shall not recognize gain or loss upon any transfer of Ccorp stock, cash, or Branch Assets that it made or may be deemed to have made to [Acorp] and [Acorp's] assumption of liabilities (§ 351(a) and 357(a)); and

(D) No gain or loss will be recognized by [Acorp] on its receipt of [Branch's] assets, or Ccorp stock and cash (§ 1032(a)).

Under State M law, domestication has the following consequences: First, all the rights and interests of Branch are deemed transferred to Acorp and Acorp is deemed to have assumed all Branch Liabilities as its own direct liabilities. Second, any Branch Assets on deposit with state insurance departments around the country are deemed held to satisfy Acorp's newly assumed obligations to policyholders, and the assets held in trust for Branch may be released to Acorp as the new domestic insurer. Third, Branch has ceased to exist as an entity with power and authority to transact insurance business, and all of its licenses have been (or are being) reconstituted or reissued in the name of Acorp.

At no time did Branch and Acorp simultaneously transact insurance business. As was the case with Branch before its domestication, Acorp is also keeping its books and filing its U.S. tax returns on a statutory accounting basis, consistent with methods reported on its NAIC annual statement, on a calendar year basis. In connection with the domestication transaction, Fcorp represents that Branch did not prepay accounts payable or accumulate accounts receivables.

Branch was subject to regulation in State M (its "port of entry") and in all other state and territorial jurisdictions where it conducted its business. The business purpose for the transaction was that Branch, as an "alien insurer," is subject to certain regulatory requirements and restrictions not imposed on domestic insurance companies. These requirements and restrictions prohibited Branch from acting and investing in the more beneficial ways which are only available to domestic insurers.

For example, State M law required that three-fifths of Branch's assets be held in trust for the benefit of policyholders. By contrast, a domestic insurer, although required to maintain a comparable level of surplus, is required to deposit only a relatively minimal amount with the state's Superintendent of Insurance and is able to hold the balance of its assets directly. The amount which Branch was required to maintain in trust was continually changing based on the changes in the value of certain assets and policy holder liabilities. Therefore, Branch maintained assets in trust in excess of the minimum amount required to avoid the need of transferring additional assets to cover shortfalls. The assets held in trust included most of Branch's portfolio of investment securities, cash and the wholly-owned real property used in Branch's business. Significant costs were incurred to administer the required trusts which are not incurred by domestic insurance companies, including costs of monitoring the amount of assets and maintaining additional bank accounts.

The trusteed assets were also subject to a greater degree of regulatory scrutiny than are the assets of a domestic insurance company. In addition to the annual statement of financial condition required to be filed by all insurers, Branch is required to prepare and file quarterly Trusteed Surplus Statements showing assets in trust and a calculation of trusteed surplus. These statements are subject to regular examination by the State M Department of insurance.

Furthermore, transactions involving trusteed assets are subject to greater restrictions than are similar transactions of a domestic insurance company. For example, holding the assets in trust precluded Branch from entering into certain transactions, such as securities lending. As to securities lending, the State M Superintendent of Insurance takes the position that the counter-party's promise to return the loaned securities may not constitute a trusteed asset. Another example was the restriction on Branch from investing in the stock of foreign insurance companies and from all other types of foreign investments except (1) obligations issued by the government of the country in which the insurer is organized; and (2) Canadian securities and investments (subject to certain additional limits). These investment restrictions, not applicable to domestic companies; has limited the yield variations and diversification strategies of Branch. Additionally, monitoring compliance with these rules on foreign investments at quarterly intervals involves administrative time and costs.

In addition, a U.S. branch's remittances to its home office (dividend equivalent amounts) are also subject to greater regulatory oversight than are dividends of a domestic insurance company. Under State M law, a domestic insurance company may declare and distribute dividends to shareholders, without any prior approval of the Superintendent, to the extent that the dividends do not exceed the lesser of 10 percent of the policyholders' surplus or 100 percent of its net investment income. A U.S. branch, on the other hand, is limited to remittances not exceeding $50,000 in any calendar quarter unless prior approval is obtained. Thus, State M's law required Branch to seek approval for virtually every distribution to its home office instead of only for extraordinary distributions.

All of these regulatory constraints contributed to the conclusion that it was preferable for Fcorp to operate in the United States through a US. subsidiary rather than in branch form. However, the timing of the domestication of Branch was attributed to other factors. Until recently, relief from the above described restrictions through domestication of Branch was outweighed by certain benefits afforded Fcorp by Country X, for operating its U.S. business in branch form. Recently, these benefits were substantially reduced, creating the impetus to domesticate Branch at this time.'. Moreover, the contemporaneous merger of Fcorp with another foreign corporation, Gcorp of Country W, provided a backdrop for an overall change which included the decision to domesticate Branch at this time.

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[1] One such reduction of benefits was in the area of accounting. Historically, the financial statements issued by Fcorp to its shareholders in Country X were prepared in accordance with Country X accounting principles. These principles differed substantially from Generally Accepted Accounting Principles (GAAP) used in the United States. In particular, the statements issued in Country X included the income and operations of only the parent company of the Fcorp Group. Earnings of wholly owned subsidiaries were only reflected in the financial statements to the extent that the subsidiaries paid dividends lo the parent company. Thus, Branch's strong economic performance would not generally have been reflected on F Corp's financial statements had it been a subsidiary. To maintain the strongest possible financial profiles in investment and business communities, Fcorp operated significant segments of its non-Country X insurance business in branch rather than subsidiary form. Only within the last few years has Fcorp begun to issue public financial statements showing consolidated income calculated in accordance with evolving Country X accounting principles. In addition. Fcorp planned to prepare its financial statements for Year 4 for the first time in accordance with International Accounting Standards. International Accounting Standards are similar to GAAP in that they provide for the reporting of consolidated revenues, earnings and other financial data. Therefore, due to changes in Country X financial reporting rules, the branch form of operation was no longer advantageous. Branch's economic status is reflected on F Corp's financials regardless of the form of business entity in which it operates.

There were also Country X tax considerations that no longer exist. Country X uses a territorial system of taxation under which Fcorp is taxable in Country X only on that portion of its income attributable to its Country X operations. Until recently, Country X's taxation regime apportioned Fcorp's worldwide net income between Country X and non-Country X operations based on relative gross premiums earned within and without Country X. Since Fcorp's net earnings per premium dollar in the United States (and other countries), computed on a separate entity basis, were disproportionately low compared to profits on Country X business, the branch form served to reduce Country X taxes by allowing Fcorp to apportion more of its worldwide net income to U.S. and other non-Country X operations. Recently, Country X tax authorities announced their intent to change the method of determining Country X taxable income of Country X and non-Country X branches. Under the new guidelines, the earnings attributable to branch operations are lo be calculated as if the branch were a subsidiary, and then excluded from the Country X tax base. Pursuant lo the new taxing method, the Country X tax consequences would be the same [illegible]

The participants entitled to benefits under the deferred benefit arrangements of Fcorp's Branch were merely general creditors of Branch with respect to any benefits under the deferred benefit arrangements. Afler the proposed transaction, they will remain as general creditors with respect to the same overall business operations that will be subject to the same creditors as before the proposed transaction. No assets will have been set aside in either an escrow account or trust fund, the participants will be able to look to Acorp to pay the deferred compensation, and the obligations of Acorp represent only unsecured promises to the participants.

APPLICABLE LAW

Section 162(a) of the Internal Revenue Code provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 163 of the Code allows, with certain exceptions, the deduction of all interest paid or accrued within the taxable year on indebtedness.

Section 164(a) of the Code provides, in part, that there shall be allowed as a deduction for the taxable year within which paid or accrued state and local, and foreign, income, war profits, and excess profits taxes (along with other kinds of taxes listed in the subsection.)

Section 404(a) of the Code provides, in part, that if contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under this chapter; but if they would otherwise be deductible, they shall be deductible under this section, subject, however, to the limitations specified in this section as to amounts deductible in any year.

Section 404(a)(5) of the Code provides, that if a plan is not included in § 404(a)(l), (2) and (3), the contributions or compensation paid or accrued on account of any employee under the plan is deductible in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan, but in the case of a plan in which more than one employee participates, only if separate accounts are maintained for each employee. For purposes of this section, any vacation pay which is treated as deferred compensation shall be deductible for the taxable year of the employer in which paid to the employee.

Section 404(b)(1) of the Code provides ...

is a method or arrangement of employer contributions or compensation which has the effect of a stock bonus, pension, profit sharing, or annuity plan, or other plan deferring the receipt of compensation, subsection (a) shall apply as if there were such a plan.

Section 263(a) of the Code generally provides that no deduction shall be allowed for capital expenditures.

Section 461(a) of the Code provides in general that the amount of any deduction shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2) of the Income Tax Regulations provides that under an accrual method of accounting, a liability is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 461(h) of the Code provides generally that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.

Section 1.461-1(a)(2)(iii)(D) of the regulations provides generally that the economic performance requirement of § 461(h) of the Code and the regulations thereunder is satisfied to the extent that any amount is otherwise deductible under § 404.

ANALYSIS

Sections 162, 163 and 164 of the Code provide deductions to a taxpayer for business expenses, interest and certain taxes, respectively. Payments of business expenses, interest and taxes of others are generally not deductible under these sections. Deoutv v. du Pont, 308 U.S. 488 (1940) (amount paid by taxpayer, as a principal shareholder of du Pont Company, to borrow shares of du Pont stock to sell to du Pont executives, to give them a financial stake in the company, was not a deductible business expense of taxpayer): Maqruder v. Supplee, 316 U.S. 394 (1941) (as purchaser, taxpayer was not allowed deduction for real estate taxes already accrued to seller, but apportioned to purchaser by agreement).

However, in certain reorganizations where [illegible] are transferred to an acquiring corporation, the acquiring corporation is allowed to deduct the liabilities when they mature or are paid. The deduction is premised on the acquiring corporation being treated as having stepped into the shoes of the transferor with respect to the liabilities. Section 381 (c)(16) of the Code specifies such treatment However, by its own terms § 381 is not applicable to § 351 transactions.

Rev. Rul. 80-198, 1980-2 C.B. 113, concludes that a transferee corporation that issued stock in exchange for all of the assets and liabilities of a cash basis sole proprietorship will report collections of the transferred accounts receivable in its income and will be allowed deductions for payments made in satisfaction of the transferred accounts payable. The revenue ruling cites Hempt Bros., Inc. v. United States, 490 F.2d 1172 (3rd Cir. 1974), cert denied, 419 U.S. 826 (1974), in support of the conclusion concerning the taxation of the transferred accounts receivable. The ruling's analysis relies on the intent of Congress that § 351(a) facilitate the incorporation of an ongoing business by making the incorporation tax free. The Service also observes in the ruling that this intent would be frustrated if either the transferor were taxed on the transfer of the accounts receivable or the transferee were not allowed a deduction for payment of the accounts payable.

In Hemot Bros., the court held a transferee corporation taxable on collections of a cash basis partnership's accounts receivable that had been transferred to it in a § 351 transaction. In rejecting the transferee corporation's argument that the doctrine of assignment of income required collections on the receivables to be taxed to the transferor partnership that generated the accounts receivables, the 3rd Circuit indicated that taxing the cash basis transferor on the transfer of accounts receivable would frustrate the specific congressional intent reflected in § 351 (a) that the incorporation of an ongoing business should be facilitated by making the incorporation tax free.[2]

Rev. Rul. 95-74, 1995-2 C.B. 36, holds that contingent environmental liabilities of an accrual basis corporate transferor assumed by an accrual basis transferee corporation in an exchange to which § 351 of the Code applies are either deductible business expenses under § 162 or capitalized expenditures under § 263, as appropriate, by the transferee corporation under its method of accounting (determined as if the transferee had owned the land subject to the contingent environmental liability for the period and in the same manner as it was owned by the transferor corporation).

Rev. Rul. 83-155, 1983-Z C.B. 38, holds that payments made pursuant to a partnership agreement to a retired partner or a spouse of a deceased partner, which

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[2] The deductibility of transferred accounts payable was not an issue in Hempt Bros.

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would have been deductible by the partnership as ordinary and necessary business expenses, are deductible as ordinary and necessary business expenses of a successor corporation.

Rev. Rul. 95-74 and Rev. Rul. 80-198 both indicate a necessity of substantial business reasons for the § 351 exchange for the deduction of the predecessor's expenses by the successor entity to be valid. Both rulings also narrow their respective applications to transactions that do not have a tax avoidance purpose. In the present case, Fcorp has already received favorable rulings that the exchange of Branch's assets and liabilities for Acorp stock constituted a valid, tax-free exchange under § 351 of the Code. The facts of this case also set forth substantial business reasons, both for the transaction itself as well as for its timing. Also, Acorp uses the same method of accounting as Branch, its predecessor, keeping its books and filing its tax returns on the statutory accounting basis, consistent with its NAIC Statement and on a calendar year basis. There is no indication of any tax avoidance motive for entering the transaction.[3]

Accordingly, we conclude and rule as follows:

1. Amounts paid or incurred for state and local income taxes may be deducted by Acorp under § 164 and other provisions of the Code to the extent such amounts would otherwise have been deductible by Branch if not assumed by Acorp.

2. Amounts paid or incurred for interest included in the tax liabilities may be deducted by Acorp under § 163 and other provisions of the Code to the extent such amounts would otherwise have been deductible by Branch if not assumed by Acorp.

3. Amounts paid or incurred for ordinary and necessary business expenses and other liabilities may be deducted by Acorp under § 162 and other provisions of the Code to the extent such amounts would otherwise have been deductible by Branch if not assumed by Acorp.

4. Amounts paid or incurred for liabilities under the deferred benefit arrangements may be deducted by Acorp under §§ 162, 404(a)(5), 404(b), 461 (h) and other provisions of the Code to the extent such amounts would otherwise have been deductible by Branch if not assumed by Acorp.

5. Provided that the deferrals under the deferred benefit arrangements did not result in

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[3] Rev. Rul. 80-198 states that factors indicating a tax avoidance motive in these situations include the prepayment of expenses and the accumulation of receivables. As heretofore mentioned, it is represented that these factors are not present in this case.

the constructive receipt of income or economic benefit to the participants, no participant in Branch's deferred benefit arrangements will be deemed to have actually or constructively received any income or economic benefit under the deferred benefit arrangements as a result of the assumption of liabilities thereunder by Holding or Acorp, as the case may be.

In addition, the taxpayer has represented that:

(1) No liability for state and local income taxes included in the "tax liabilities," no interest liability included in the "tax liabilities," and no portion of the deductible amount of the "other liabilities" to be assumed by Holding or Acorp, as the case may be, had been taken into account by Branch or Holding, as the case may be, prior to the transfer, and therefore no such amount had given rise to deductions for, or resulted in the creation of or increase in basis in any property of Branch or Holding, as the case may be.

(2) No liabilities under the deferred benefit arrangements to be assumed by Holding or Acorp, as the case may be, had been taken into account by Branch or Holding, as the case may be, prior to the transfer, and therefore no such amount had given rise to deductions for, or resulted in the creation of or increase in basis in any property of Branch or Holding, as the case may be.

Based on the facts presented and the representations given, we further rule as follows:

6. Any liability for state and local income taxes, any interest liability included in the tax liabilities, and the deductible amount of the other liabilities to be assumed by Holding or Acorp. as the case may be, will be excluded for purposes of §§ 357(c) and 358(d).

7. The liabilities under the deferred benefit arrangements to be assumed by Holding or Acorp, as the case may be, will be excluded for purposes of §§ 357(c) and 358(d).

Except as specifically ruled above, no opinion is expressed as to the federal tax treatment of the transaction under any other provisions of the Code and the Income Tax Regulations that may be applicable or under any other general principles of federal income taxation. No opinion is expressed as to 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.

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This ruling is directed only to the taxpayer(s) who requested it. Pursuant to the power of attorney on tile in this office, a copy of this ruling will be sent to your representative. Section 6110(k)(3) of the Code provides that a private letter ruling may not be used or cited as precedent.

Sincerely yours,

Assistant Chief Counsel
(Income Tax & Accounting)

by Douglas A. Fahey

Douglas A. Fahey, Assistant to the Branch Chief
Branch 5

cc:

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