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

OFFICE OF
CHIEF COUNSEL

August 20, 2001

Number: **200149009**
Release Date: 12/7/2001
CC:DOM:CORP
TL-N-7097-00
UILC: 1502.12-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
(Large and Mid-Size Business)

CHARLES W. MAURER, JR.
ATTORNEY (LMSB)

FROM: Edward S. Cohen
Chief, CC:CORP:2

SUBJECT: Regence Ordering Rule

This Chief Counsel Advice responds to your memorandum. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent. Unless otherwise specified, citations refer to the regulations effective at the time of the transaction.

LEGEND

Date 1 =

Date 2 =

Date 3 =

Year 1 =

ISSUES

1. Where a consolidated group includes two organizations described in Internal Revenue Code § 833 (I.R.C. § 833 organizations) and a non-insurance subgroup, how should the taxable income limitation on the I.R.C. § 833(b) deduction be computed?

2. Where a consolidated group includes two I.R.C. § 833 organizations, should the taxable income limitation on the I.R.C. § 833(b) deduction be computed separately for each organization, or should all such organizations be combined for computation purposes?

3. If an I.R.C. § 833 organization joins a consolidated group on Date 2, and ratably allocates its items between the separate and consolidated periods, how should the I.R.C. § 833(b) deduction be computed?

4. If an I.R.C. § 833 organization joins a consolidated group on Date 2, and its short taxable year ending Date 1 resulted in a loss which created a SRLY NOL deduction for that organization in the consolidated return for the year ending Date 3, how should the SRLY limitations be applied in computing the I.R.C. § 833(b) deduction?

CONCLUSIONS

1. An I.R.C. § 833 organization that is a member of a consolidated group calculates its I.R.C. § 833 deduction in the same manner as it would if it filed a separate return. For purposes of computing the I.R.C. § 833 deduction taxable income limitation, each I.R.C. § 833 organization should compute its own taxable income as defined by I.R.C. § 832(a) (including the deductions allowed by I.R.C. § 833(c)) by only taking into account its health-related items as required by I.R.C. § 833(b)(4).

2. Each I.R.C. § 833 organization should separately compute its own I.R.C. § 833 deduction and its own deduction limitation under I.R.C. § 833(b)(2) by only using the corporation's own health-related items.

3. Where an I.R.C. § 833 organization allocates items ratably between separate and consolidated periods, the corporation determines its I.R.C. § 833 deduction for the entire year and then allocates part of the deduction to each period.

4. The SRLY limitation does not affect the calculation of the I.R.C. § 833 deduction. Sub calculates its I.R.C. § 833 deduction and then determines the deduction limitation by determining taxable income under I.R.C. § 832 taking into account its health-related NOLs.

FACTS

Parent, an organization described under I.R.C. § 833, is the common parent of a consolidated group that includes non-insurance companies. Parent acquired Sub, another I.R.C. § 833 organization, on Date 2.

For Sub's short taxable year ending Date 1, Sub filed a separate return. For the period from Date 2 to Date 3, Sub was included in Parent's consolidated return. Sub reported a loss for its short taxable year ending Date 1, without taking into consideration an available net operating loss carryforward. Sub also reported a loss for the short taxable year it was a member of the Parent. The Parent consolidated group had positive taxable income for the tax year ending Date 3.

Sub calculated the I.R.C. § 833 deduction amount, absent the taxable income limitation of I.R.C. § 833(b)(4), on a full-year basis using its ending adjusted surplus from Year 1. Sub took this figure and ratably allocated the amount to the short taxable year ending Date 1 and the consolidated return year ending Date 3. Sub reported the figure allocable to the period it was included in the consolidated return as its I.R.C. § 833 deduction. The taxpayer determined there was no I.R.C. § 833(b)(2) limitation on the deduction. Sub contributed no taxable income to the group.

LAW AND ANALYSIS

1. Where a consolidated group includes two I.R.C. § 833 organizations and a non-insurance subgroup, how should the taxable income limitation on the I.R.C. § 833(b) deduction be computed?

We concur with the conclusion in your memorandum. Section 833(a) allows I.R.C. § 833 organizations a deduction for any taxable year equal to the excess (if any) of (A) 25 percent of the sum of (i) the claims incurred during the taxable year and liabilities incurred during the taxable year under cost-plus contracts, and (ii) the expenses incurred during the taxable year in connection with the administration, adjustment, or settlement of claims, over (B) the adjusted surplus as of the beginning of the taxable year. I.R.C. § 833(b). This deduction is limited by I.R.C. § 833(b)(2), which provides that "the deduction determined under paragraph (1) for any taxable year shall not exceed taxable income for such taxable year (determined without regard to such deduction)."

Section 832(a) provides, in part, that "taxable income" means the gross income as defined in I.R.C. § 832(b)(1) less the deductions allowed by I.R.C. § 832(c). Thus, because I.R.C. § 832(c)(10) allows a deduction for NOL carryovers permitted under I.R.C. § 172, the I.R.C. § 833 organization must reduce its taxable income attributable to health-related items by the portion of its NOL carryover attributable to health-related items in determining the I.R.C. § 833(b)(2) limitation.

Section 833(b)(4) provides that any determination under this subsection shall be made by only taking into account items attributable to the health-related business of the taxpayer. Thus, the computation of the amount of the deduction under I.R.C. § 833(b)(1) and the taxable income limitation under (b)(2) take into

account only the items that are attributable to the health-related business of the I.R.C. § 833 organization.

To the extent the organization has no health-related taxable income after applying health-related NOLs, it is not entitled to a I.R.C. § 833 deduction. In the facts presented above, under a separate entity calculation of the I.R.C. § 833 deduction, Sub is not entitled to an I.R.C. § 833 deduction for either its short taxable year ending Date 1 or for the portion of the year it is included in Parent's consolidated return ending Date 3, provided that Sub did not have health-related taxable income for the taxable year. I.R.C. § 833(b)(4).

The consolidated return regulations modify the calculation of tax for corporations filing a consolidated return. However, the Code is applicable to the group to the extent the regulations do not exclude its application. Treas. Reg. § 1.1502-80.

In this case, the consolidated return regulations do not change the application of I.R.C. § 833. Section 1.1502-11 sets forth how a consolidated group determines its taxable income. This section provides that the consolidated taxable income for a consolidated return year shall be determined by taking into account the separate taxable income, as defined by Treas. Reg. § 1.1502-12, of each member of the group, and the specific enumerated items that are calculated on a consolidated basis. Section 833 deduction is not listed in Treas. Reg. § 1.1502-11 as one of the items calculated on a consolidated basis. Therefore, a member entitled to the I.R.C. § 833 deduction must factor in the deduction when determining separate taxable income under Treas. Reg. § 1.1502-12 unless that regulation section provides otherwise.

Section 1.1502-12 provides that the separate taxable income of a member is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations subject to specified enumerated modifications. Section 833 is not one of the listed modifications. Therefore, an I.R.C. § 833 organization allowed by the Code to take the I.R.C. § 833 deduction is allowed the deduction in computing its separate taxable income under Treas. Reg. § 1.1502-12.

Because the consolidated return regulations do not modify the calculation of the I.R.C. § 833 deduction, Parent and Sub each calculate the deduction, including the limitation thereon, under the Code (I.R.C. § 833) as if each filed a separate return. Because I.R.C. § 833(a) provides that these organizations determine their taxable income as stock insurance companies under I.R.C. § 832, I.R.C. § 832 is used to determine taxable income for purposes of the limitation. However, only health-related items are used in the calculation.

2. Where a consolidated group includes two I.R.C. § 833 organizations, should the taxable income limitation on the I.R.C. § 833(b) deduction be computed separately for each organization, or should all such organizations be combined for computation purposes?

We agree with your conclusion. As stated above, the deduction and limitation should be calculated separately for each organization in the consolidated group. In a separate return context, each I.R.C. § 833 organization must calculate its taxable income under I.R.C. § 832 using only health-related items to determine the I.R.C. § 833(b)(2) limitation on the deduction. I.R.C. § 833(b)(4).

3. If an I.R.C. § 833 organization joins a consolidated group on Date 2, and ratably allocates items between the separate and consolidated periods, how should the I.R.C. § 833(b) deduction be computed?

The information submitted indicates that the taxpayer elected to allocate items pursuant to Treas. Reg. § 1.1502-76(b)(2)(ii). However, that section is effective for acquisitions after January 1, 1995. For acquisitions prior to January 1, 1995, such as the acquisition of Sub on Date 1, former Treas. Reg. § 1.1502-76(b)(4)(i) provided that the taxable income to be reported in each such return shall be determined on the basis of the Target member's income shown on its permanent records (including work papers). If a portion of an item of income or deduction to be reported in each return cannot be clearly determined from the permanent records, the portion of such item to be included in each such return shall be the amount of the item for the full taxable year ratably allocated to each return based on the number of days included in each return. Former Treas. Reg. § 1.1502-76(b)(4)(ii).

Whether or not the items necessary to calculate the I.R.C. § 833 deduction can be determined from Sub's permanent records is a factual question that may decided by your office. If you determine that the items cannot be clearly determined from the permanent records, then we concur with your conclusion that the I.R.C. § 833 deduction is determined on a full-year basis and then ratably allocated to each period, rather than allocating each item to a period and then calculating the allowable deduction separately for each period.

If you determine the items necessary to calculate the I.R.C. § 833 deduction can be determined from the permanent records, then the entire calculation should be done by treating each period as a separate tax year. See Former Treas. Reg. § 1.1502-76(d). For example, as you point out, "adjusted surplus" forms the base for the deduction calculation. "Adjusted surplus" is a cumulative amount adjusted each tax year by the preceding taxable years's adjusted taxable income or decreased by the preceding taxable year's adjusted net operating loss. I.R.C. § 833(b)(3). In this case, "adjusted surplus" should be calculated for the short

period ending Date 1 and again for Sub's year ending Date 3 by treating each period as a separate taxable year. Former Treas. Reg. § 1.1502-76(d).

4. If an I.R.C. § 833 organization joins a consolidated group on Date 2, and its short taxable year ending Date 1 resulted in a loss that created a SRLY NOL deduction for that organization in the consolidated return for the year ending Date 3, how should the SRLY limitations be applied in computing the I.R.C. § 833(b) deduction?

We agree with your conclusion. Because each I.R.C. § 833 organization calculates its own I.R.C. § 833 deduction and its taxable income limitation separately as if it filed a separate return, the fact that the Sub has losses incurred in a separate limitation year (SRLY) does not change Sub's I.R.C. § 833 calculation.

Section 1.1502-1(e) and (f), in general, define a separate return limitation year (SRLY) as a taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group. Section 1.1502-21(c)(2)(ii) limits the offsetting of net operating losses arising in a SRLY against consolidated taxable income.

As discussed above, the consolidated return regulations do not change the calculation of the I.R.C. § 833 deduction. The SRLY limitations only apply when calculating consolidated taxable income. Therefore, in determining the I.R.C. § 833 deduction, Sub's health-related NOLs from prior years would offset any positive taxable income from health-related items for the year ending Date 3 even though SRLY would restrict the use of the NOL against the Parent group's consolidated taxable income in the return for the taxable year ending Date 3.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This memorandum does not address the application of Treas. Reg. § 1.172-5(a) which determines the amount of net operating loss which shall be carried to other taxable years. Application of Treas. Reg. § 1.172-5(a) was addressed in previous memoranda. The National Office's position on the application of Treas. Reg. § 1.172-5(a) has not changed.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call Guy Barry at (202) 622-8012 if you have any further questions.

Edward S. Cohen
Chief, Branch 2 (Corporate)