International Life Insurance Company (formerly State Insurance Co. of Kentucky) v. Commissioner of Internal Revenue, 51 T. C. 765 (1969); 1969 U. S. Tax Ct. LEXIS 191

Unearned premiums received in an insurance company acquisition are taxable income, while assumed liabilities do not reduce the purchase price or constitute income.

Summary

International Life Insurance Co. acquired health and accident policies from the insolvent Republic Casualty Insurance Co. The Tax Court held that the unearned premiums transferred to International Life were taxable income, not a reduction of the purchase price. However, the court ruled that existing liabilities assumed by International Life did not reduce the purchase price or constitute income. The court also denied International Life's attempt to amortize any part of the consideration paid for the policies, as they had no determinable useful life.

Facts

In 1957, International Life Insurance Co. (formerly State Insurance Co. of Kentucky) entered into a reinsurance agreement with Republic Casualty Insurance Co. , an insolvent insurer. Under the agreement, International Life assumed all of Republic's health and accident policies in force as of January 1, 1957. In exchange, International Life paid Republic one-half of the annual premium on each policy, less unearned premiums and existing liabilities as of the effective date. The unearned premiums amounted to $55,528. 27 and the existing liabilities totaled $32,990. 70. International Life issued certificates of assumption to Republic's policyholders, effectively substituting itself for Republic. The policies could be canceled or modified by International Life at any time and were subject to renewal upon payment of additional premiums.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in International Life's income tax for 1960 and 1961, stemming from a 1957 net operating loss carryover. The issue was whether International Life erroneously reported the unearned premiums and assumed liabilities as income and whether it could amortize the consideration paid for the policies. The case proceeded to the United States Tax Court, which issued its decision on February 17, 1969.

Issue(s)

1. Whether the unearned premiums on the policies assumed by International Life should be netted against the gross cost to determine the consideration paid.
2. Whether the unearned premiums constituted income to International Life.
3. Whether the existing liabilities assumed by International Life were income to the

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company or includable in “losses incurred” under section 832(b)(5) of the Internal Revenue Code.
4. Whether any part of the consideration paid by International Life may be amortized.

Holding

1. No, because the unearned premiums were a form of payment to International Life and did not reduce the consideration paid.
2. Yes, because the unearned premiums represented advance payments by policyholders for future coverage, and their transfer to International Life constituted income.
3. No, because the existing liabilities were not income to International Life and should not be included in “losses incurred,” as they were incurred by Republic prior to the acquisition.
4. No, because the health and accident policies had no determinable useful life, and the covenant not to compete was not severable from the overall purchase price.

Court’s Reasoning

The court applied the statutory framework of section 832 of the Internal Revenue Code, which defines taxable income for insurance companies. It rejected International Life’s argument that the transaction was a simple assumption reinsurance, instead treating it as a purchase of assets and liabilities. The court held that the unearned premiums were income to International Life, as they represented advance payments for future coverage. The court cited cases like *Hoosier Casualty Co. v. Commissioner* and *Commonwealth Title Co. v. Rothensies* to support this conclusion. Regarding the existing liabilities, the court determined that they were not income and should not reduce the purchase price, as they were incurred by Republic before the acquisition. The court also denied amortization of the consideration paid, as the policies had no determinable useful life due to International Life’s ability to cancel, modify, or alter them at any time. The court rejected the analogy to insurance expirations and life insurance policies, which have fixed durations. Finally, the court held that the covenant not to compete was not severable from the overall purchase price, as its value was too remote and integral to the transaction.

Practical Implications

This decision clarifies the tax treatment of unearned premiums and assumed liabilities in insurance company acquisitions. Attorneys advising clients on such transactions should ensure that unearned premiums are reported as income by the acquiring company, rather than as a reduction of the purchase price. Existing liabilities assumed in the transaction should not be treated as income or as a reduction of the purchase price. The decision also highlights the difficulty of amortizing the purchase price of insurance policies with indefinite durations, as the

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court will closely scrutinize claims of a determinable useful life. Practitioners should be cautious in attempting to allocate portions of the purchase price to covenants not to compete, as the court will require clear evidence that such covenants have independent value. This case may be distinguished from situations involving fixed-term policies, where amortization may be more readily available.

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