SOCIETY OF ACTUARIES

Article from:

Taxing Times

September 2006 – Volume 2, No. 2

Removal of Profit/Loss Separation Rule from Life/Nonlife Regulations Eliminates Tax Issue from Securitizing Triple-X Business

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There are numerous important tax issues that arise in the securitization of Triple-X life insurance business by consolidated groups that include both life insurance companies and other companies (insurance and otherwise), *i.e.*, life/nonlife consolidated groups. Among these issues are questions about the effect of the Interal Revenue Service (IRS) regulations governing the conditions under which a life/nonlife consolidated group can file a consolidated federal income tax return. Recently, the IRS eliminated one of the more amorphous tax rules that at times was a stumbling block in Triple-X securitization transactions. Unfortunately, however, the IRS left an equally amorphous consolidated return rule untouched.

Background

In 1999, the NAIC adopted Valuation of Life Insurance Policies Model Regulation, more commonly known as Regulation Triple-X, a statutory reserving method for certain life insurance products. In brief, Regulation Triple X requires life insurance companies to establish statutory reserves well in excess of expected losses from level premium term life insurance business. That requirement can cause substantial surplus strain for affected life insurance companies, and for that reason, many life insurance companies that write level premium term life insurance business have sought to securitize their Triple-X business.

In its most basic form, the securitization of Triple-X life insurance business entails (1) the establishment of a life insurance subsidiary that is not subject to the Triple-X reserving requirements; (2) the cession of the Triple-X business from the parent life insurance company to the newly established subsidiary; and (3) the issuance by the life insurance subsidiary (or a holding company) of debt in the capital markets to fund the subsidiary's surplus requirements.

In many cases, life insurance companies that securitize their Triple-X business are members of groups of corporations that include other types of corporations as well ("nonlife" companies) for purposes of filing federal income tax returns. Traditionally, life insurance companies were not permitted to join nonlife companies in filing consolidated federal income tax returns. That prohibition was eliminated, however, when Congress enacted section 1504(c)(2) of the Internal Revenue Code,[1] giving life insurance companies permission to consolidate with nonlife companies beginning in 1981. In 1983, the IRS finally issued regulations (the "life/nonlife" consolidated return regulations) containing various requirements for life insurance companies that sought to join in a life/nonlife consolidated return.

The life/nonlife consolidated return regulations were drafted in terms of the somewhat complicated system by which life insurance companies were taxed at the time, which entailed three "phases":

- Phase I—A life insurance company's tax base was the lesser of the company's "gain from operations" or its "taxable investment income."
- Phase II—If a life insurance company's gain from operations exceeded its taxable investment income, 50 percent of the excess was added to the tax base.
- Phase III—An amount equal to the other 50 percent of the excess of gain from operations over taxable investment income was added to the life insurance company's "policyholders surplus accounts." Amounts added to a company's policyholders surplus account were taxed when distributed to a company's stockholders.

In 1984, Congress completely revised the system for taxing life insurance companies, eliminating the three-phase system in favor of tax rules substantially like those that apply to corporations generally. *See generally* Tax Reform Act of 1984, Pub. L. No. 98-369. As a result, however, some of the 1983 life/nonlife consolidated return regulations became difficult to apply, and the rationales underlying others seemed no longer valid. Nonetheless, the regulations were not revised and are still in effect.

Under the life/nonlife consolidated return regulations, before a life insurance company is permitted to join in filing a life/nonlife consolidated return, it must have satisfied certain affiliation requirements during the five preceding taxable years of the parent of the consolidated group, a period called the "base" period. Thus, throughout the base period, the life insurance company:

- Must have been in existence and have otherwise been a member of the consolidated group, engaged in the active conduct of a trade or business.

- Must not have experienced a change in its tax character, *i.e.*, the Code provision under which it is taxed, as the result of an acquisition of assets from outside the group in one or more transactions not conducted in the ordinary course of its trade or business; and

- Must not have undergone a disproportionate asset acquisition attributable to the acquisition of assets from outside the group in transactions not conducted in the ordinary course of its trade or business.

A life insurance company that satisfies those requirements is referred to as an "eligible" life insurance company, and upon satisfying the requirements must join in the life/nonlife consolidated return for as long as the life insurance company remains eligible.[2]

Thus, in a typical Triple-X securitization, a life insurance subsidiary that is formed by a member of a life/nonlife consolidated group must satisfy these eligibility requirements for the base period in order for its losses to be used by other members of the group. Taking five years to do so, however, would significantly impair a good number of securitizations.

The Tacking Rule

Fortunately, the life/nonlife consolidated return rules contain a provision that can substantially accelerate the satisfaction of the eligibility requirements. The provision, called the "tacking rule," applies to a life insurance company that is formed from within a life/nonlife consolidated group by one or more eligible life insurance company members of the group. Under the tacking rule, the newly formed life insurance subsidiary is treated as a having satisfied the eligibility requirements to the extent that the forming member has satisfied them. Briefly stated, the requirements are:

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- At any time, at least 80 percent of the assets that the newly formed life insurance subsidiary has acquired outside of the course of its ordinary trade or business must have been acquired from an eligible member of the group in a tax-free transaction.

- Both the forming member and the newly formed life insurance subsidiary must be taxable as life insurance companies.

- The new subsidiary must not have undergone a disproportionate asset acquisition—at any time during a consolidated return year—that is attributable to one or more "special acquisitions," *i.e.*, must not have undergone a significant acquisition of assets in one or more transactions not conducted in the ordinary course of its trade or business, whether from inside or outside the life/nonlife consolidated group.[3]

- Finally, before the withdrawal of this requirement —as discussed above—if both the forming member and the new subsidiary are life insurance companies, the transfer should not have reasonably been expected to separate profitable activities from loss activities.

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Prohibition against Separating Profit Activities from Loss Activities.

There are two elements of the tacking rule that are notable for their elusive meaning: (1) the rule against separating profitable activities from loss activities and (2) the meaning of a life insurance company's "ordinary course of business." The IRS has now withdrawn the rule prohibiting the separation of profits and losses. Its rationale for doing so is based, first, on

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the extensive revisions to the system of taxing life insurance companies made in 1984, and, second, on the provision in the American Jobs Creation Act of 2004, Pub. L. No. 108-357, by which Congress permitted the tax-free distribution of policyholders surplus account balances. The IRS and the Treasury Department concluded that these two developments, taken together, have rendered the rule prohibiting separation of profits and losses "no longer relevant under current law."[4] T.D. 9258 (Apr. 24, 2006).

The separation of profits and losses rule was somewhat troublesome for tax practitioners involved in Triple-X securitizations. The Triple-X business is generally expected to generate significant losses in the early years, and the ceding company's retention of the Triple-X business could cause the ceding company significant surplus strain, hence the need for the securitization. In one light, therefore, the cession of Triple-X business to a newly formed subsidiary could be considered to result in the separation of profit activities from loss activities. The Triple-X business would generally be expected to cause more-or-less the same losses for the ceding company as it would for the newly formed life insurance subsidiary, and on that basis, the separation of profits and losses rule should not apply. Confusing matters further, the Triple-X business can be expected to become profitable sometime in the future, and there is no guidance about when (if ever) the separation of profits and losses might occur without creating a problem under the regulations. For these and other reasons, the IRS's withdrawal of the rule from the life/nonlife consolidated return regulations is a welcome development.

Definition of "Ordinary Course"

As welcome as the withdrawal of the separation of profits and losses rule is, it is unfortunate that the IRS did not use the opportunity to define an equally ambiguous phrase, *i.e.*, the ordinary course of a life insurance company's trade or business, which is used in the general eligibility requirements as well as in the tacking requirements. Both the 80 percent test and the disproportionate asset acquisition rule refer to the ordinary course of business, but the regulations make no attempt to define the term.[5]

The IRS has never explained in any published authority how one might determine what the ordinary course of a life insurance company's trade or business might be.[6] There are at least two ways to view the question. The first, and seemingly more reasonable approach, is to treat as the ordinary course of business anything that a life insurance company might reasonably do to advance its business. In most cases, a license to conduct a life insurance business permits a life insurance company to conduct reinsurance business, as well. No additional license or permission is needed. On that basis, the assumption of Triple-X business by a life insurance subsidiary in a Triple-X securitization ought to be considered to be in the ordinary course of the subsidiary's trade or business.

Another approach, which the IRS has advocated informally, is that the ordinary course of a life insurance company's trade or business should refer only to those businesses that have been regularly carried on. The difficulty with that approach is that it leaves completely uncertain the point at which a life insurance company's activities become "regularly carried on." In its rulings under the life/nonlife consolidated return regulations, the IRS has steadfastly avoided providing a definition.

For example, in LTR 91-15-028, the IRS ruled that the change in a nonlife insurance company's tax character, caused by the acquisition of life insurance business from outside the life/nonlife consolidated group, did not disqualify the company from being a member of the group, because the acquisition had been in the ordinary course of the insurance company's trade or business. As a condition of issuing a favorable ruling, however, the IRS had insisted that the taxpayer represent that it had regularly entered into reinsurance contracts with other insurance companies (thus enabling the IRS to conclude that the reinsurance had been in the ordinary course of the company's trade of business).[7]

The real question is whether the ordinary course of a life insurance company's business is what a life insurance company is permitted under its charter to do, or rather what the life insurance company has done many times in the past. If it is the latter, one is left wondering just how

many times a life insurance company would have to engage in reinsurance transactions before reinsurance became the ordinary course of life insurance company's trade or business. A more reasonable determination whether a transaction occurs in the ordinary course of a life insurance company's trade or business would be to ask whether company's reinsurance activity is functioning as a going concern and is performing the activities for which it was organized.[8] If so, it would seem that transactions that are permitted under the company's charter should be considered to be in the ordinary course of the company's trade or business. Such a definition would make it easier for newly formed life insurance companies to rely on the tacking rule without impairing any of the safeguards or restrictions that the IRS has incorporated into the life/nonlife consolidated return regulations.

Conclusion

The IRS itself has informally observed that the life/nonlife consolidated return regulations are outmoded and out of date, but undertaking a wholesale revision, the IRS explains, would be an enormous challenge. Moreover, the IRS has explained that it is unlikely to undertake such a challenge because, even though Congress revised the system of taxing life insurance companies in 1984, it did not disturb section 1504(c)(2) which is the Code provision that permits life/nonlife consolidation. As a result, the IRS feels that some regulatory guidance is needed for life/nonlife consolidated returns, even if the existing regulations are not a perfect fit, unless and until Congress repeals section 1504(c)(2).

The IRS's concern is certainly valid, but clarifying a phrase that plays such an important role in the consolidation of life and nonlife companies would not require a wholesale revision of the regulations. Providing a reasonable and workable definition of the phrase "ordinary course of a trade or business" would seem to be a small step that could provide a good deal of clarity, not only for the Triple-X securitization transactions, but also for companies subject to the life/nonlife consolidated return regulations generally. ◂

References

1) Tax Reform Act of 1976, Pub. L No. 94-455, § 1507(a). Except as otherwise designated, all statutory references in this article are references to the Internal Revenue Code (the "Code").

2) Nonlife companies in the life/nonlife consolidated group can also be either eligible or ineligible. That distinction, however, is not relevant to this article.

3) A "special acquisition" occurs for any member of the life/nonlife consolidated group at the end of any taxable year in which at least 75 percent the member's insurance reserves, assets, or premiums are attributable to one or more acquisitions of assets from outside the group in transactions not conducted in the ordinary course of its trade or business. Whether a special acquisition is disproportionate is generally determined at the end of each base period, *i.e.*, at the end of each taxable year of the common parent. If a subsidiary is relying on the tacking rule for its eligibility, however, the disproportionate asset acquisition rule applies at all times during any taxable year of the common parent.

4) The IRS and the Treasury Department included the prohibition against separating profit activity from loss activity in the life/nonlife consolidated return regulations because the IRS and the Treasury Department were concerned that the interplay of the "three-phase" system of taxing life insurance companies and the so-called bottom-line consolidated return method then in effect, could enable life insurance companies to separate profitable activities from loss activities and thereby reduce consolidated life insurance company taxable income. T.D. 9258, *supra*.

5) The phrase "regularly carried on" also appears in the more general eligibility requirements. In order to be included in a life/nonlife consolidated group, a life insurance company must not have had a change in its tax character, *i.e.*, the provision of the Code under which it is taxed, that is attributable during, the base period, to any acquisition of assets in one or more in transactions not conducted in the ordinary course of the company's trade or business. This requirement cannot be satisfied by means of the tacking rule.

6) The tax law is replete with definitions of the phrase "ordinary course of business." *See, e.g., Deputy v. DuPont*, 308 U.S. 488 (1940).

7) *See also* LTR 94-41-021 (same representation and same conclusion). It is important to note, however, that representations by taxpayers do not constitute affirmative conclusions by the IRS.

8) *See generally* 6 J. Mertens, Law of Federal Income Taxation § 25.11.

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