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NEW DEVELOPMENTS FOR LIFE/NONLIFE CONSOLIDATED RETURNS AND THE DISPROPORTIONATE ASSET ACQUISITION RULES

By Lori J. Jones

The Internal Revenue Service (IRS) recently issued three private letter rulings (PLRs) dealing with the application of the disproportionate asset acquisition rules under the life/nonlife regulations. As described in detail in this article, the PLRs reach conclusions generally favorable to the filing of life/nonlife consolidated returns and address certain issues not specifically addressed in the regulations. For example, the PLRs shed some light on what types of transactions might give rise to special acquisitions and, specifically, how the amount of premiums or reserves attributable to special acquisitions should be measured with respect to reinsurance contracts that are later modified in the ordinary course of business.

BACKGROUND

Treas. Reg. § 1.1502-47 contains rules that must be satisfied in order for a life insurance company to be an eligible corporation includible in a life/nonlife consolidated return. (By contrast, an ineligible nonlife company can be included in the life/nonlife consolidated return, but its net operating losses may not be used to absorb affiliated life insurance company taxable income.) Under the general rule, to be included in the life/nonlife consolidated return, a life insurance company: (i) must have been a member of the affiliated group for five taxable years prior to the time it can join in a life/nonlife consolidated return (“base period”); (ii) must have been engaged in the active conduct of a trade or business during the base period; (iii) must not have experienced a “change in tax character” during the base period; and (iv) must not have experienced a “disproportionate asset acquisition” during the base period. Treas. Reg. § 1.1502-47(d)(12)(i). If a life insurance company does not satisfy these tests, it can be included in the life/nonlife consolidated return only if the “tacking rules” of Treas. Reg. § 1.1502-47(d)(12)(v) are satisfied so that the base period of the “old corporation” is included in (or “tacks” onto) the calculation of the base period for a “new corporation.”

The tacking rules generally require that at least 80 percent of the new corporation’s assets acquired outside the ordinary course of business result from transfers qualifying under



section 351 or 381 of the Internal Revenue Code from the old corporation. The old corporation must have the same tax character as the new corporation and the new corporation must not undergo a disproportionate asset acquisition at the end of the taxable year during which the first condition (the 80 percent test) is met. In addition, if the tacking rules are satisfied but the corporation undergoes a disproportionate asset acquisition, it will become ineligible at that time.

Whether the general rules or the tacking rules apply, a disproportionate asset acquisition can preclude life/nonlife consolidation. The tax policy underlying the disproportionate asset acquisition rules is that a corporation should not be considered to be the same company during the five-year waiting period for life/nonlife consolidation if its insurance business has fundamentally changed during the five-year period from outside asset acquisitions. Treas. Reg. § 1.1502-47(d)(12)(viii) states that in order to be eligible a corporation must not undergo during the base period a disproportionate asset acquisition which is attributable to an acquisition (or series of acquisitions) of assets from outside the group in transactions not conducted in the ordinary course of business (which are referred to as “special acquisitions”). Whether an acquisition results in a disproportionate asset acquisition depends on all the facts and circumstances including the following factors and rules:

- (i) The portion of the insurance reserves at the end of the base period attributable to special acquisitions;
- (ii) The portion of the fair market value of the assets (without reduction for liabilities) at the end of the base period attributable to special acquisitions;
- (iii) The portion of the premiums generated during the last taxable year of the base period attributable to special acquisitions;
- (iv) Money or other property contributed to a corporation by a shareholder that is not a member of the group is not a special acquisition; and

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- (v) If a new corporation has relied on the tacking rules to become an eligible member of the life/nonlife consolidated group, it will become an ineligible corporation if it experiences a disproportionate asset acquisition during a consolidated taxable year.

For this purpose, a corporation will not experience a disproportionate asset acquisition unless 75 percent of one factor (whether or not listed above) is attributable to special acquisitions. Treas. Reg. § 1.1502-47(d)(12)(viii)(D). Therefore, the measurement of the respective reserves, assets and premiums attributable to the special acquisition is essential in order to determine whether the 75-percent threshold is met or exceeded.

RECENT PRIVATE LETTER RULINGS

The three recent PLRs address the disproportionate asset acquisition rules in connection with several different proposals to restructure holdings of U.S. subsidiaries by a foreign parent.¹ All of the PLRs appear to be supplemental to PLR 200644021 (July 28, 2006), which also included numerous rulings on the disproportionate asset acquisition rules.² (PLRs 200906006 (Oct. 17, 2008) and 201006002 (Nov. 6, 2009) both refer to the 2006 PLR and PLR 201047019 (Aug. 17, 2010) refers to PLR 200906006.)

Among other things, PLR 200906006 ruled on the proposed mergers of Lifeco 2 and 3 (members of the U.S. Parent 2 Group) into Lifeco 1 (member of the U.S. Parent 1 Group) (referred to as Lifeco 1 Transaction). PLR 200906006 contained a taxpayer representation that the transfer of assets in the Lifeco 1 Transaction was a special acquisition. Presumably, this representation confirms that the taxpayer concluded that the mergers of Lifeco 2 and 3 into Lifeco 1 were transactions from outside the group not in the ordinary course of business (and, thus, a special acquisition). (However, while the PLR contained rulings interpreting the regulations, it did not specifically conclude that the Lifeco 1 Transaction did not result in a disproportionate asset acquisition.) The notable rulings of the various PLRs are described below.

Base Period

In general, the regulations require the testing for disproportionate asset acquisitions at the end of the base period, *i.e.*, generally defined as the common parent's five taxable years immediately preceding the group's taxable year for which the consolidated return and determination of eligibility are made. See Treas. Reg. § 1.1502-47(d)(12)(ii). Therefore, the base period is a rolling five taxable year test. On this point, the IRS

has ruled that determinations of disproportionate asset acquisitions are made by taking into account only those factors that are attributable to special acquisitions occurring during the relevant base period.³

In PLR 201047019, the taxpayer was concerned about how the volatility in the financial markets might affect the insurance reserves, assets and premiums of Lifeco 1's business and whether it might cause Lifeco 1 to undergo a disproportionate asset acquisition within the base period that included the mergers of Lifeco 2 and 3 into Lifeco 1. (Presumably, the taxpayer believed that there would not have been a disproportionate asset acquisition if such determination were to be made immediately after the mergers on the basis of the rulings in PLR 200906006.) It was further represented that Lifeco 1 had no intention to undertake any other special acquisitions in the foreseeable future and that any reinsurance transactions with related persons either have satisfied (or will satisfy in the future) the arm's-length standard of section 482. Based on the representations, the IRS concluded that the transfer of assets and liabilities from Lifeco 2 and 3 into Lifeco 1 will not constitute disproportionate asset acquisitions for *any* base period that includes the mergers. Therefore, the mergers in the PLR were taken into account only once at the end of the year which included the transaction. This appears to be a taxpayer-friendly reading of the regulations which arguably require the testing to be done at the end of *every* base period which included the mergers.

Measurement of Reserves Attributable to Special Acquisitions

The first factor listed in the regulations in determining disproportionate asset acquisitions is the portion of the insurance reserves the acquiring company holds at the end of the base period attributable to special acquisitions. As noted earlier, the threshold question is whether the reserves attributable to special acquisitions account for 75 percent or more of the acquiring company's total reserves (as defined in section 816(c)).⁴

PLR 200906006 also provides guidance on issues relating to reinsurance treaties. It holds in ruling (3) that if any insurance agreement, including any reinsurance treaty, to which Lifeco 2 or 3 is a party is assumed by Lifeco 1 in the Lifeco 1 Transaction, and, in the ordinary course of Lifeco 1's business, is later amended or modified by Lifeco 1 to permit the reinsurance of additional insurance contracts, the amount of insurance reserves and premiums attributable to these additional insurance contracts shall not be treated as premiums or



reserves acquired in a special acquisition. The IRS arguably could have taken the position that any modifications also were special acquisitions so this ruling also appears taxpayer-favorable. Ruling (2) provides that the amount of the life insurance reserves and premiums of Lifeco 1 attributable to the special acquisitions related to the Lifeco 1 Transaction will be determined by reference to the insurance reserves and premiums attributable to the insurance agreements, including any reinsurance treaties, that have been entered into by Lifeco 2 and 3 at the time of the Lifeco 1 Transaction, that are in effect at the time of the Lifeco 1 Transaction and that continue in effect during the relevant measurement period or that continue to be in effect at the relevant measurement date. While also taxpayer-friendly, this approach appears to require the taxpayer to determine the premium and reserves allocable to the reinsurance agreement and then separately to the modified portion of the agreement.

Measurement of Assets Attributable to Special Acquisitions

Another factor is the portion of the fair market value of the gross assets of the acquiring company at the end of the base period that is attributable to special acquisitions. In PLR 200906006, ruling (4) provides that the amount of assets attributable to special acquisitions of Lifeco 1 will be determined by reference to all of the assets held by Lifeco 2 and 3 at the time of the Lifeco 1 Transaction, transferred to Lifeco 1 in that Transaction, and held by Lifeco 1 during the relevant measurement period or on the relevant measurement date. It further provides (i) that where Lifeco 1 acquires an asset following the Lifeco 1 Transaction other than in the ordinary course of business, and (ii) that asset acquisition is attributable to, or otherwise related to, a disposition of an asset previously held by Lifeco 2 or 3 at the time of the Lifeco 1 Transaction, the newly acquired asset will be considered an asset previously

held by Lifeco 2 or 3 to the extent of the relinquished asset's value at the time of disposal of that asset. This also appears to be a favorable ruling for the taxpayer because it does not treat the new acquisitions as special acquisitions even though the assets are purchased outside the ordinary course of business. However, the rule will require the potentially burdensome tracing of the asset values.

Measurement of Premiums Attributable to Special Acquisitions

The last factor that must be measured in terms of the 75-percent test relates to premiums generated during the last taxable year of the base period attributable to special acquisitions. In this case, Treas. Reg. § 1.1502-47(d)(12)(viii)(D) specifically identifies the last taxable year of the base period. Ruling (6) of PLR 200906006 states that the term "last taxable year of the base period" means the taxable year immediately preceding the group's taxable year for which the consolidated return and determination of eligibility is made. In both PLR 200906006 and PLR 201006002, the IRS ruled that the term "premiums" used in connection with any insurance agreement, including any reinsurance treaty, means (i) the "gross amount of premiums and other consideration," as defined in section 803(b)(1), including any negative modco reserve adjustment, less (ii) the sum of (a) any return premiums, including any experience refunds, positive modco reserve adjustment, and other policyholder dividend or reimbursement of any policyholder dividend (in each case attributable to an indemnity reinsurance agreement) and (b) any consideration payable pursuant to any indemnity reinsurance agreement." See PLR 200906006 (ruling 5); PLR 201006002 (ruling 14). Rulings (2) and (3) of PLR 200906006 described earlier in this article apply to both reserves and premiums.

However, in PLR 201047019 (ruling 2), the IRS appears to modify the definition of premiums and eliminate (or at least reduce) the reduction of premium by any consideration payable in an indemnity reinsurance transaction. That is, after ruling that the mergers of Lifeco 2 and 3 into Lifeco 1 will not constitute a disproportionate asset acquisition for *any* base period (to address the volatility issue discussed earlier), it then states that the premiums that Lifeco 1 must take into account will *not be* reduced by any arm's-length premiums that Lifeco 1 pays to a reinsurer as the initial consideration for the reinsurer entering into an indemnity reinsurance transaction with Lifeco 1. This appears inconsistent with the previous PLR and the definition of premiums under section 803.

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In PLR 201006002, the transactions in question generally involved reinsurance transactions rather than mergers. In that case, the IRS applied section 351 to the transfer of assets pursuant to an assumption reinsurance transaction, but apparently viewed the indemnity reinsurance and co-modco reinsurance transactions as taxable transactions. As stated above, ruling (14) contained a general definition of premiums. Ruling (15) states that the reference to premiums generated during the last taxable year of the base period which are attributable to special acquisitions will not include the premiums that each company receives as consideration for entering into the indemnity coinsurance transaction and the co-modco transaction. This also appears to be a favorable ruling for the taxpayer presumably on the basis that the taxable reinsurance transactions are not special acquisitions.

CONCLUSION

In summary, the PLRs indicate that the IRS is willing to entertain ruling requests and, in some cases, be flexible in their approach to the disproportionate asset acquisition provisions in the life/nonlife regulations. ◀

END NOTES

- ¹ In unrelated PLR 200905020 (Oct. 21, 2008), the IRS also addressed the eligibility rules and concluded that the subsidiary would be treated as having engaged in the active conduct of a trade or business throughout every day of the base period despite the fact that it no longer issued new policies and was in run-off.
- ² PLR 201006002 is described in more detail in, *The Mystery of PLR 201006002*, 6 *TAXING TIMES* 41, Vol. 6, Issue 3 (Sept. 2010).
- ³ See PLR 200906006, ruling (8). This last ruling also was included in PLR 200644021.
- ⁴ Even though the regulations refer to total reserves in section 801(c), the proper current reference is to the definition of total reserves in section 816(c) as was confirmed in ruling (7) of PLR 200906006.

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