SOCIETY OF ACTUARIES

Article from:

Taxing Times

February 2013 – Volume 9 Issue 1

T³: *TAXING TIMES* TIDBITS

CIGNA UPDATE—MUCH ADO ABOUT NOTHING

By Peter H. Winslow

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *pwinslow@scribnerhall.com*.

In the September 2011 edition of *Taxing Times*,[1] this author discussed the novel reinsurance argument presented in the *CIGNA*[2] case that relates to the persistent issue on the "retroactivity" of National Association of Insurance Commissioners (NAIC) actuarial guidelines (AGs) for purposes of computing tax reserves. The so-called "retroactivity issue" is really a misnomer. The question is: To what extent should a new AG apply for tax purposes for future years to contracts issued prior to the NAIC's adoption of the AG?

To review the bidding, under I.R.C. § 807(d), life insurance reserves generally are required to be computed in accordance with the tax reserve method prescribed by the NAIC (CRVM or CARVM) in effect on the date of issuance of the contract. The legislative history offers guidance as to how to interpret CRVM and CARVM for tax purposes. First, the company is required to use the method prescribed by the NAIC in effect on the date of issuance of a contract, and take into account any factors recommended by the NAIC for such contracts. The factors referred to in the legislative history are those recommended by the NAIC in model regulations and AGs recommended by the NAIC. Second, where no such factors are recommended, or for contracts issued prior to the NAIC's adoption of guidance, the company should look to the prevailing state interpretation of the Standard Valuation Law, *i.e.*, the interpretation that has been adopted by at least 26 states, if one exists. Finally, if there is no specific NAIC guidance or prevailing state interpretation, the company should use its statutory reserve approach as long as it was a permissible interpretation of CARVM or CRVM at the time the contract was issued.

The *CIGNA* case involved tax reserves computed under AG 34 for guaranteed minimum death benefits (GMDB) for tax years 2003 and 2004 attributable to variable annuity contracts issued prior to the NAIC's adoption of AG 34. CIGNA made a novel argument based on the fact that it had reinsured the risks from another insurer and CARVM technically may not apply to reserves held under reinsurance contracts. In such a case, CIGNA argued, the applicable Code provision is I.R.C. § 807(d)(3)(A)(iv) which provides that, for contracts not covered by CRVM or CARVM, the reserve method is the method prescribed by the NAIC "as of" the date of issuance of the contract. By its terms, AG 34 applied to reinsured risks under variable annuities with GMDB even though CARVM technically may not apply. Because the NAIC made AG 34 applicable to all contracts issued on or after Jan. 1, 1981, CIGNA contended that AG 34 is the NAIC-prescribed method "as of" that date.

The IRS disagreed and argued that reinsured annuity risks are still covered by CARVM, and that, because the contracts were issued prior to the NAIC's adoption of AG 34, CIGNA was required to use the method that was consistent with the prevailing state interpretation of CARVM for variable annuities with GMDB. Then, in a surprising development, the IRS conceded the case by asserting to the court that CIGNA's use of AG 34 reserves yielded a reasonable approximation of reserves computed using the prevailing state interpretation of CARVM as of the time the contracts were issued. This was a puzzling assertion because the Internal Revenue Service ("IRS") also acknowledged in its court filings that there was no uniform state interpretation of how CARVM applied to variable annuities with GMDB before AG 34 was adopted.

CIGNA refused to accept the IRS's concession. According to a pre-trial filing of the IRS, the IRS believed that CIGNA's refusal was motivated by its desire to apply AG 43 to its reinsured risks beginning in 2009 when that guidance was adopted by the NAIC.[3] If its "as of" argument under AG 34 prevailed, then presumably the same analysis would apply to permit AG 43 to have "retroactive" treatment as well. The Tax Court allowed the case to go to trial in September 2011, leaving open the possibility that the court either would enter a decision on the merits or would decide, in light of the IRS's concession of the tax in dispute, that the case was moot.

The Tax Court made its decision (or non-decision) in an opinion filed on Sept. 13, 2012. Not surprisingly, the court declined to decide the case on the merits, holding that it was

moot. A significant factor in the opinion is the court's reliance on the IRS's representation that it would not challenge CIGNA **or other taxpayers** that use AG 34 to compute tax reserves for GMDB for contracts issued prior to AG 34's adoption by the NAIC.

Other than the IRS's significant statement that AG 34 tax reserves will not be challenged, there is not much to be gleaned from the *CIGNA* case. But, two observations on the overall "retroactivity" issue can be made.

First, it may be fortuitous that the court did not decide the *CIGNA* case on the merits because, if the court had adopted either party's position, it may not have come to the best legal answer. Under the Sixth Circuit's well-reasoned opinion in *American Financial,*[4] CIGNA's AG 34 tax reserves should have been allowable because they were consistent with statutory reserves, were a permissible interpretation of CARVM at the time the contracts were issued and were not contrary to a majority-of-states uniform interpretation of the SVL.[5]

Second, the IRS may have learned an important lesson from its decision to challenge CIGNA's tax reserves. As was the case in the *American Financial* case, the IRS found itself having disallowed tax reserves computed in accordance with an NAIC guideline interpreting the same CARVM that existed when the contracts were issued. Yet, at the same time, in both *American Financial* and *CIGNA*, the IRS did not have a clear picture of what the "correct" tax reserve should have been under its 26-state position. The IRS's best option was to concede the *CIGNA* case and avoid another defeat. In light of the IRS's experience in *American Financial* and *CIGNA*, and with many tax reserve issues arising from the NAIC's adoption of AG 43 still unresolved, the IRS is likely to be wary of further litigation and we can expect guidance from the IRS that clarifies its position.

END NOTES

1. Peter H. Winslow, *What Is the Tax Reserve Method "As Of" the Date of Issuance of the Contract?*, Society of Actuaries Taxing Times, Vol. 7, Iss. 3 (Sept. 2011).
2. *CIGNA Corp. v. Comm'r,* T.C. Memo. 2012-266 (Sept. 13, 2012).
3. Memo. Supporting Resp. Motion Entry of Decision at 6, July 14, 2011, Dkt No. 013645-09, ECF No. 0049.
4. *American Financial v. U.S.*, 678 F.3d 422 (6th Cir. 2012).

THE IRS EXCUSES AN UNINTENDED SEPP FAILURE

By Mark E. Griffin

The Internal Revenue Service ("IRS") in PLR 201235029[1] considered the exception to the 10 percent penalty tax under section 72(t)[2] for certain distributions that are part of a series of substantially equal periodic payments (the "SEPP Exception"). Consistent with the position it has taken in other private letter rulings, the IRS in PLR 201235029 concluded generally that an unintended failure to make payments as scheduled under the SEPP Exception would not result in a modification of the stream of payments that would trigger the application of the penalty tax. PLR 201235029 is of interest because it involves the distribution of an additional payment, unlike earlier rulings involving the failure to make a scheduled payment.

The Penalty Tax and the SEPP Exception

Section 72(t)(1) provides that if a taxpayer receives any amount from a "qualified retirement plan,"[3] including an IRA, the taxpayer's income tax for the year in which the amount is received is increased by an amount equal to 10 percent of the portion of the amount which is includible in gross income, subject to certain exceptions. The SEPP Exception provides an exception to this 10 percent penalty tax for distributions which are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and his or her designated beneficiary.[4] Rev. Rul. 2002-62 sets forth three methods of making periodic payments that will be considered substantially equal periodic payments within the meaning of the SEPP Exception: the required minimum distribution method, the fixed amortization method, and the fixed annuitization method.[5]

However, if the series of payments is modified (other than by reason of death or disability) within five years, or before the employee attains age 59½, the previously avoided penalty tax is recaptured (with interest) in the year of the modification.[6] Under this recapture rule, the taxpayer's tax for the first year in which the modification occurs is increased by an amount equal to the tax that would have been imposed absent the SEPP Exception, plus interest for the deferral period.[7] Neither the

CONTINUED ON PAGE 60

Mark E. Griffin is a partner in the Washington, D.C. Law firm of Davis & Harman LLP and may be reached at *megriffin@davis-harman.com.*

Code nor the regulations under section 72 defines or describes what constitutes a modification to a stream of payments for this purpose.[8]

PLR 201235029

In PLR 201235029, Taxpayer A, age 50, was receiving monthly distributions from her IRA annuity in a manner that satisfied the SEPP Exception to the 10 percent penalty tax under section 72(t). Each distribution was made from Financial Institution A, the custodian of the IRA, to Financial Institution B, which then transmitted the distribution to Taxpayer A. On Date 1, Taxpayer A directed Financial Institution B to stop distributing funds at that time, and she began taking distributions directly from Financial Institution A. Nevertheless, she received a duplicate distribution from Financial Institution B on Date 2 and, despite requests by Taxpayer A, Financial Institution B failed to take the action requested to offset the duplicate distribution. Taxpayer A asserted that the additional distribution was due to a mistake made by Financial Institution B. She represented that she did not intend to modify the series of substantially equal periodic payments being made from her IRA annuity, had no reason to believe that Financial Institution B would distribute an additional amount on Date 2, and did not use the additional distribution for any other purpose.

Taxpayer A was concerned that the duplicate distribution could be viewed as resulting in a modification to the stream of substantially equal periodic payments being taken from her IRA. If so, and because she had not attained age 59½, her tax for the year in which the duplicate distribution was made would be increased under the recapture rule by an amount equal to the tax that she would have incurred previously absent the SEPP Exception, plus interest for the deferral period. For this reason, Taxpayer A requested a ruling from the IRS that the duplicate distribution did not result in a modification that would trigger the application of the recapture rule.

The IRS concluded that the additional distribution would not be considered a modification of the series of substantially equal periodic payments, and thus would not trigger the recapture rule or be subject to the 10 percent penalty tax under section 72(t)(1). In addition, Taxpayer A was granted a period of 60 days from the issuance of the private letter ruling to transfer the duplicate distribution back into her IRA annuity.

Observations and Conclusion

Neither the Code nor the regulations under section 72 provide that a taxpayer can self-correct, or that the IRS can waive, a modification to a stream of payments being made under the SEPP Exception. Absent some relief, even an inadvertent and unintentional failure to make payments in accordance with the SEPP Exception would constitute a modification to the series of periodic payments under the exception, trigger the application of the recapture rule, and result in increased tax to the taxpayer equal to the tax that would have been imposed absent the SEPP Exception (plus interest). The IRS in PLR 201235029 helped the taxpayer avoid these adverse tax consequences by taking the view that the failure—the duplicate distribution—did not constitute a modification in the first instance. This view is supported by the fact that (1) the failure was unintended, (2) the failure occurred as a result of an error on the part of a financial institution, (3) the duplicate distribution was not used by the taxpayer for any other purpose, and (4) the taxpayer would correct the failure by transferring the duplicate distribution back into her IRA annuity.

PLR 201235029 is noteworthy because it involves an additional distribution that caused distributions to fail to be made in accordance with the SEPP Exception. The IRS has taken a similar view in other private letter rulings to excuse certain unintended failures to make the necessary payments under the SEPP Exception where the taxpayer took an additional distribution to correct the failure.[9] Implicit in these rulings is that taxpayers who have failed to take the necessary distributions under the SEPP Exception might find it necessary to obtain a private letter ruling that the failure is excused by the IRS in order to avoid the application of the recapture rule. ◀

END NOTES

1 Dated June 7, 2012, and released to the public on Aug. 30, 2012. A private letter ruling cannot cited as precedent, and only the taxpayer who received it can rely on it. *See* section 6110(k)(3) of the Internal Revenue Code of 1986, as amended (the "Code").

2 Unless otherwise indicated, the term "section" refers to a section of the Code.

3 A "qualified retirement plan" for this purpose includes (1) a qualified plan under section 401(a), (2) a qualified annuity under section 403(a), (3) a section 403(b) contract, and (4) an individual retirement account under section 408(a) and an individual retirement annuity under section 408(b) (collectively, "IRAs"). *See* section 72(t)(1); section 4974(c).

4 Section 72(t)(2)(A)(iv).

5 2002-2 C.B. 710, *modifying* Q&A-12 of Notice 89-25, 1989-1 C.B. 662.

6 Section 72(t)(4).

[7] *Id.*

[8] Section 72(q) includes a 10 percent penalty tax, SEPP Exception, and recapture rule for non-qualified annuity contracts that are virtually identical to those described above in section 72(t) for qualified retirement plans. See section 72(q)(1), (2)(D), and (3). The Treasury Department and the IRS have taken the position in Notice 2004-15, 2004-1 C.B. 526, that they will treat a distribution as satisfying the SEPP exception applicable to non-qualified annuity contracts in section 72(q) if the taxpayer uses one of the methods described in Notice 89-25, as modified by Rev. Rul. 2002-62, to determine whether the payment is part of a series of substantially equal periodic payments.

[9] *See* PLR 201051025 (Sept. 30, 2010); PLR 200930053 (Apr. 27, 2009); PLR 200835033 (June 3, 2008); PLR 200601044 (Oct. 12, 2005); PLR 200503036 (Oct. 25, 2004).

SOME RECENT LOOKS AT THE CONCEPT OF INVESTOR CONTROL

By Susan J. Hotine

Susan J. Hotine is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *shotine@scribnerhall.com.*

The Internal Revenue Service (IRS) recently released two private letter rulings dealing with "investor control—PLR 201235001 (May 30, 2012) and PLR 201240018 (June 22, 2012). The issue of investor control generally has been associated with variable contracts and involves determining whether, based on general tax ownership principles, the holder of a contract with an insurance company possesses sufficient incidents of ownership over the investment assets being used to fund the company's contract liabilities that the holder should be treated as the owner of the assets for tax purposes. Whereas PLR 201235001 specifically involves variable annuity contracts, PLR 201240018 asks the question regarding indexed-linked investment options under a deferred annuity contract.

PLR 201235001

PLR 201235001 describes an insurance company's restructuring of a pooled, open-ended separate account of real estate investments (Separate Account) such that substantially all of the Separate Account assets will be transferred into a wholly owned subsidiary, which in turn will drop the real estate assets down into a second wholly owned subsidiary, both of which are described as disregarded entities for tax purposes (Disregard 1 and Disregard 2, respectively). Under this restructuring, the Separate Account will hold interests in Disregard 1, along with a few assets not transferred (that is, what remains after transferring "substantially all" of its assets). Funds from both pension and non-pension contracts are invested in the Separate Account. To the extent that any non-pension contracts continue in existence under the ultimate restructuring plan, the company will move interests in Disregard 1 equal in value to the cash value of the non-pension contracts from the Separate Account into a new Separate Account 2. As a result, pension contract funds will be invested through the Separate Account and non-pension contract funds will be invested through Separate Account 2. Following the establishment of Separate Account 2, the company will transfer the non-pension contract interests in Disregard 1 to NewCo, ownership interests of which will be publicly available.[1] Finally, although the company had and will continue to have complete discretion with respect to the investment of pension contract funds (within a broadly defined investment strategy for real estate), it will be limited in its investment of non-pension contract funds to only Disregard 1. A stated purpose of the restructuring of the company's pooled, open-ended real estate investment account into Disregard 1 and Disregard 2 is to allow interests in Disregard 1 to be owned, directly or indirectly, by non-insurance investors that are unrelated to the company. The IRS provides the requested rulings (1) that the company continues to be the owner of the assets underlying the pension contracts and (2) that the holders of the non-pension contracts will be treated as the owners of the assets underlying those contracts.

After the restructuring, the pension contract deferred annuities and the non-pension contract deferred annuities will look very similar from an economic perspective because each will reflect investment (directly or indirectly) in the Disregard 1/Disregard 2 structure, which will be a publicly available investment structure that holds substantially all of the real estate investments originally held by the insurance company as the Separate Account. The pension contract holders will know that after the restructuring substantially all of their funds will be invested in the publicly available Disregard 1/Disregard 2 real estate investment structure. However, under the general real estate investment strategy provided for in the contracts, the insurance company is not required to put new funds in that structure or even to keep the current investments there, and the company made no promise to do so. In other words, the choice to invest in the publicly available Disregard 1/Disregard 2 structure is the company's and not that of the pension contract holders. By contrast, the company retained no such investment discretion with respect to the funds of non-pension contract holders. Going forward, the non-pension contract holders know that the company will invest non-pension con-

CONTINUED ON **PAGE 62**

tract funds only in the Disregard 1/Disregard 2 structure and that investment essentially will define the non-pension contracts. As a result of the company no longer having any choice regarding the underlying investments for the non-pension contracts, and because those underlying assets are comprised of a single, publicly available investment vehicle, the non-pension contract holders are treated as having made the choice to invest in a publicly available investment. The non-pension contract holders are treated as having investor control and so are treated as the owners of the underlying investment assets for tax purposes. Thus, the differing conclusions for the requested rulings seem to rest on the fact that the insurance company continues to retain complete discretion with respect to how pension contract funds will be invested in real estate investments, but does not have investment discretion with respect to non-pension contract funds.

The second ruling in PLR 201235001 is similar to that contained in PLR 200601007 (Jan. 06, 2006). As in PLR 200601007, the facts in PLR 201235001 clearly indicate that the non-pension contracts will not qualify as annuity contracts for tax purposes after the restructuring because they will not comply with section 817(h) diversification requirements. However, rather than the status of the contracts as annuities, the taxpayer's requested ruling is about ownership of the underlying assets—specifically that the contract holders, and not the taxpayer company, should be considered the tax owner of the underlying investment assets for the non-pension contracts.[2] It seems that the important consequence of the contract holders being treated as the owners of the underlying investment assets is that the contract holders are required to account for the investment income, gains or losses attributable to those assets for tax purposes and, thus, the company is not.

PLR 201240018

Although PLR 201240018 presents itself as an investor control ruling, it focuses on non-variable investment options of what otherwise is a variable deferred annuity contract. The variable investment options provide returns that reflect the investment return and market value of assets held by the company in sub-accounts of a separate account ("SA1") the assets of which are segregated from the general asset account and creditors. By contrast, the non-variable investment options provide formula-based returns that are indexed-linked to C1 and C2 (presumably indexes based on certain asset groups) so they reflect changes in the specified indexes over a stated duration. The facts state that the issuing company will hold the assets it purchases to support its indexed-linked liabilities in another account ("SA2") that is part of its general asset account, that the company will use its sole discretion in determining the nature and extent of any investments it makes to support these liabilities, and that the guaranteed indexed-linked return shields the contract holders from the investment risk associated with these assets. Although the indexed-linked investment options are characterized as allowing contract holders to diversify their deferred annuity contract portfolios by adding returns based on the indexes, the facts state that the holders' risk exposure is limited because losses on the company's actual investments will not affect the formula-based indexed-linked returns. Although the amount of cash in SA2 will equal the cash values of the indexed-linked investment amount attributable to the related contracts, the company has no legal obligation to invest in any specific assets and, if the contract holder makes a withdrawal from its indexed-linked investment option, the company can choose whatever general account assets it wants to use to pay the proceeds.

PLR 201240018 provides a detailed analysis of how the company has all the various ownership attributes associated with the assets supporting the indexed-linked investment options—a analysis that is like what might be said with respect to any general account assets underlying contracts that provide or assume a guaranteed return with respect to premiums paid into the contracts. And, as it might for any contract funded by general account assets, the PLR concludes that the issuing company enjoys the benefits and bears the burdens of owning the assets and should be treated as the owner for federal tax purposes. Conversely, the ruling notes that unlike in the investor control rulings the contract holders choosing indexed-linked investment options have no control over the purchase and disposition of the assets and receive a formula-based return that is completely independent of the investment return of the assets. It also notes that the contract holders are not investing directly in C1 and C2 (which is consistent with the fact that the indexed-linked investment return is based on a guaranteed formula and not the actual return on specific assets) and that the C1 and C2 indexed returns they receive are available only by purchasing the indexed-linked investment options of the contract (and not outside the contract). PLR 201240018 then concludes that the contract holders have no investment control over the investments supporting the indexed-linked investment options and therefore would not be treated as the owners of those assets for federal income tax purposes.

The issue of investor control arises under a variable contract because the contract reflects the investment return and market value of specific assets, which are segregated from a company's general asset account creditors and contract holders, and because the funds of the variable contract are in fact invested in those assets. Although these factors are not discussed explicitly in the investor control rulings, they are implicit in the definition of a variable contract. These factors generally are not present for contracts with guarantees that are supported by the company's general asset account, and these factors did not seem to be present for the indexed-linked investment options described in PLR 201240018. Even though certain assets within the general asset account had been identified by the company (SA2) as supporting the guarantee of the formula-based return for the indexed-link investment options, the facts seem to indicate that other creditors or contract holders of the general asset account would have a claim against those assets if needed (a fact that is generally true with respect to all contracts written on the company's general asset account). Although the facts set forth in PLR 201240018 appear to be very detailed in describing how the indexed-linked investment options work, numerous acronyms are used and are not well defined, making it difficult to say for certain to what extent the indexed-linked returns on the contract's cash value really are linked to specific assets owned by the company. Thus, it is not obvious on the face of the ruling's analysis why an investor control ruling was sought. However, there is a footnote that seems to indicate that the formula-based index-linked returns can be negative as well as positive, perhaps making the indexed-linked investment options a riskier investment than the usual guaranteed return options in other contracts based on the company's general account. The taxpayer may have sought the ruling because it thought that the existence of such an investment risk for the holder raised investor control issues. In any case, PLR 201240018 seems to confirm that, if the liabilities for contract guarantees are supported by assets in the insurance company's general asset account (and the company possesses all the asset ownership characteristics generally associated with the general asset account), the contract holder will not be treated as the tax owner of any assets held by the company to hedge or support those liabilities, even if the liabilities reflect guarantees that vary through use of a formula that can cause the guaranteed return to be both positive or negative. ◀

END NOTES

[1] Although it is not stated in the ruling, presumably Disregard 1 will cease to be a disregarded entity for tax purposes when NewCo holds interests therein.

[2] Note that the conclusion that a contract holder should be treated as the owner of the underlying assets does not necessarily mean that the remaining contract is not an annuity. *See* PLRs 200949007 (July 30, 2009) and 200949036 (July 30, 2009); PLR 201001016 (Sept. 14, 2009) (all holding that certificates providing customers of mutual funds with guaranteed minimum withdrawal or income benefits for the life of the customer will be treated as annuity contracts even though the certificates do not provide a cash value surrender benefit before the payments).

IRS ADOPTS BENEFICIAL APPROACH TO TACKING RULE

By Lori J. Jones

For those who stay up at night worrying about whether a newly formed life insurance company can join an existing life/nonlife consolidated group, a new private letter ruling ("PLR") may be a reason for a good night's sleep. When a new life insurance company is excluded from the group, any ordinary and capital losses generated by the life company during a five-year waiting period cannot be used by the consolidated group during that period (or vice versa), and the tax effect of reinsurance or other intercompany transactions with the new company could differ. In PLR 201210015 (Mar. 9, 2012), the Internal Revenue Service (IRS) allowed a life insurance subsidiary to satisfy the "tacking rule" in Treas. Reg. section 1.1502-47(d)(12)(v) and join in the life/nonlife consolidated group as a result of a tax-free section 351 transaction that occurred several years after the subsidiary's formation and initial capitalization.[1] The key fact in the PLR was that the second section 351 transaction was of a sufficient size to constitute 80 percent of the assets acquired by the subsidiary outside the ordinary course of business at that time and, for the first time in that later year, the same tax character test was also met.

Lori Jones is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *ljones@scribnerhall.com*.

When a new life insurance or non-life insurance company is formed or acquired by a member of an existing life/nonlife consolidated group, the entity is treated as an ineligible corporation, unless the tacking rule applies. The basis for these rules

CONTINUED ON **PAGE 64**

is found in section 1504(c)(2) and section 1503(c)(2). Under section 1504(c)(2), no life insurance company can be included in a life/nonlife consolidated group until it has been a member of the affiliated group for the five taxable years immediately preceding a taxable year for which the consolidated return is filed. Under section 1503(c)(2), a nonlife company is includible in the group, but its net operating losses (NOLs) cannot be utilized against life insurance company income if such taxable year precedes the sixth taxable year such members have been members of the same affiliated group.[2]

The tacking rule in Treas. Reg. section 1.1502-47(d)(12)(v) is intended to apply when the new corporation is enough of a successor (using the term loosely and not as specifically defined in the consolidated return regulations) to the "old corporation" so that it can utilize (tack) the eligible status of the old corporation and join in the group as an eligible corporation. The rule contains four separate but interrelated requirements. The first requirement is that, at any time, 80 percent or more of the new corporation's assets it acquired (other than in the ordinary course of its trade or business) were acquired from the old corporation in one or more transactions described in section 351(a) or 381(a).[3] The asset test is applied by using the fair market value of assets on the date they were acquired and without regard to liabilities.[4] The second condition is that, at the end of the taxable year during which the first condition is first met, the old corporation and the new corporation must have the same tax character. The third condition is that, at the end of the taxable year during which the first condition is first met, the new corporation does not undergo a disproportionate asset acquisition as defined in Treas. Reg. section 1.1502-47(d)(12)(viii). The last condition is that, if there is more than one old corporation, the first two conditions apply to all of the corporations. Specifically, the last condition states that the tax character test must be met by all of the old corporations transferring assets taken into account in meeting the 80 percent test described above.

There have not been a significant number of private letter rulings or other IRS guidance addressing issues under the tacking rule. Rulings which have considered the tacking rule include: (i) TAM 9816001 (Nov. 20, 1997) (which concludes that the 80 percent test must take into account all transfers of assets that were made pursuant to an integrated plan so that satisfaction or failure to satisfy the tacking rule depended on whether employees transferred by a life insurance company member to a nonlife company member were an asset and, if so, whether the value of that asset comprised more than 20 percent of the total nonlife company's assets), (ii) FSA 862 (Oct. 8, 1992) (which concluded that the 80 percent test and the same tax character test had not been satisfied and the company was not eligible to make a life/nonlife election), and (iii) PLR 9211050 (Dec. 18, 1991) (where an eligible life insurance company purchased the stock of target for cash and then merged into target and the IRS held that the New Target (the merged entity) qualified as an eligible member of the life/nonlife group because 96 percent of New Target's assets were acquired from the eligible life insurance company in a section 381 transaction.)

PLR 201210015 focuses on the interplay between the first, second and fourth requirements of the tacking rule. Based on these requirements, one might conclude that if a corporation was formed and capitalized in one year and, in that same year, the new corporation and the old corporation in the section 351 or 381 transaction had different tax characters, e.g., one qualified as a nonlife insurance company and one qualified as a life insurance company, the tacking rule might never be satisfied. However, the PLR illustrates that such a failure can be cured in a later year if there is an additional asset transfer and, immediately after the additional transfer, 80 percent of the new corporation's assets have been received in a section 351 (or 381) transaction from the old transferor and both companies have the same tax character at the end of that later taxable year.

In the PLR, Parent was formed in Year 1 and Lifeco, a wholly owned subsidiary of Parent, was formed in Year 2. In Year 3, Lifeco formed a nonlife company (Sub). Prior to Year 5, Sub was licensed to issue life insurance products in certain jurisdictions, but had not conducted an insurance business. In Year 4, Parent elected to file a life/nonlife consolidated return, which included Lifeco and Sub.[5] In Year 5, Sub was expected to begin writing insurance business and qualify as a life insurance company under section 816. In Year 5, but prior to commencement of its insurance activities, Lifeco will contribute to Sub at least Amount 2 of additional capital (the "Capital Contribution"). (Prior to the Capital Contribution, Sub held investment assets which represented the capital contributed upon Sub's formation plus investment earnings (referred to as "Amount 1"). The PLR does not provide any additional information about the makeup of assets constituting Amounts 1 and 2.) It was represented that, immediately after the Capital Contribution, at least 80 percent of Sub's assets (based on the fair market values on the date of the Capital Contribution without liabilities) will have been acquired from Lifeco on account of the Capital Contribution. The Capital Contribution

also qualified as a section 351 transfer and it was represented that both Lifeco and Sub will qualify as life insurance companies at the end of Year 5.

In conclusion, the PLR is helpful because it allows the tacking rule to be satisfied even though Lifeco and Sub did not have the same tax character in the year in which the 80 percent is arguably "first" met, Year 3. Instead, the IRS concluded that the rule could be satisfied in a later year, Year 5, when both the 80 percent test and the same tax character test would be satisfied as a result of an additional capital contribution. This may be helpful in those instances when the new corporation is formed and capitalized by a life insurance company, but the reinsurance which will enable it to qualify as a life insurance company for federal tax purposes does not occur until a later year, if additional capital is also transferred to the new life company in the later year.[6] Such a result is likely the better answer from the consolidated group's point of view than if the tacking rule is not satisfied and the life insurance company has to file a separate federal income tax return during the five-year waiting period. ◂

END NOTES

1 Section 351 of the Internal Revenue Code of 1986, as amended, provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons in exchange for stock and immediately after the exchange such person(s) are in control of the corporation under section 368(c).

2 Under the regulations, in order to be an eligible corporation, a corporation must, for the five-year base period, (i) have been in existence and a member of the group, (ii) engaged in the active conduct of a trade or business, (iii) not experience a specifically defined change in tax character, and (iv) not undergo disproportionate asset acquisitions. Treas. Reg. section 1.1502-47(d)(12)(i). The reference to affiliated group in both section 1504(c)(2) and 1503(c)(2) is without regard to the exclusion for life insurance companies under section 1504(b)(2).

3 Section 381 applies to a section 332 liquidation or a reorganization described in section 368, other than a reorganization described in section 368(a)(1)(B) (voting stock for voting stock) or 368(a)(1)(E) (recapitalization).

4 There are some additional rules in the regulations regarding the 80 percent test. They include requirements that: (i) assets acquired in the ordinary course of business are excluded from total assets only if they were acquired after the new corporation became a member of the group (determined without section 1504(b)(2)), and (ii) assets that the old corporation acquired from outside the group in transactions not conducted in the ordinary course of its trade or business are not included in the 80 percent (but are included in total assets) if the old corporation acquired those assets within five calendar years before the date of their transfer to the new corporation.

5 According to a conversation with IRS Chief Counsel attorneys, there was sufficient time between Year 2 and Year 4 for Lifeco to satisfy the eligibility rules under Treas. Reg. section 1.1502-47(d)(12)(i). In other words, Year 4 was not two calendar years after Year 2, but was more than five taxable years after Year 2.

6 In the PLR, the IRS presumably concluded that change in Sub's tax character in Year 5 was not a prohibited change in tax character under Treas. Reg. section 1.1502-47(d)(12)(viii), *i.e.*, it was not a change attributable to an asset acquisition either within or outside the group in a transaction that is not conducted in the ordinary course of its trade or business. This rule similarly would have to be taken into account in the transaction proposed above in order for the new corporation to satisfy the tacking rule.

TAX COURT MEMO DECISION EXPLAINS THE TAXATION UPON THE TERMINATION OF A SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENT

By Erinn Madden and Deborah Walker

The U.S. Tax Court addressed the tax consequences associated with the rollout of a split-dollar life insurance arrangement in *Neff v. Commissioner*, T.C. Memo 2012-244. Because this arrangement was entered into prior to finalization of the split-dollar regulations, the case analyzes the Internal Revenue Service (IRS) guidance for arrangements entered into on or before Sept. 17, 2003, including Revenue Rulings 64-328 and 66-110 and Notice 2002-8.

Erinn Madden is a tax senior manager with Deloitte Tax LLP and may be reached at *erinnmadden@deloitte.com.*

Deborah Walker is a tax senior manager with Deloitte Tax LLP and may be reached at *Debwalker@deloitte.com.*

In March 2002, the taxpayers entered into split-dollar arrangements with their company under which the company paid premium payments on several life insurance policies owned by the taxpayers and family limited partnerships. Under this arrangement, the taxpayers agreed that on the termination of the policies or the split-dollar life insurance arrangement, the company was entitled to the lesser of the total premiums it paid or the cash surrender value of the policies. In December 2003, the company and taxpayers decided to terminate the arrangement. Prior to the termination, the company paid premiums of $842,345 and the cash surrender value was $877,432. No premium payments were made by the company after December 2003. An accounting firm calculated the present value of the reimbursement right of the company in the event of the taxpayers' death at age 85 using a 6 percent discount rate as

CONTINUED ON **PAGE 66**

$131,969. The taxpayers reimbursed the company $131,969, to release its interest in the policy and the taxpayers from any reimbursement obligation related to the additional $710,376 premiums paid. No amount was included on the taxpayers' return related to the termination of the arrangement. On audit, the IRS determined that the taxpayers realized taxable income of $710,376.

Under the rules in effect before the split-dollar regulations were finalized, the Tax Court indicated that the taxpayers were required to include the cost of the economic benefit in income each year less any amount contributed by the taxpayer. However, the taxpayers did not include any economic benefit in income. Although the taxpayers argued that the arrangements remained in effect, the Tax Court found that even though there was no written documentation of the termination, the arrangements were unwound and an effective rollout occurred because the company was released from its obligation to make premium payments and the company made no premium payments after December 2003. The taxpayers realized income under section 61, or alternatively the taxable transfer of property under section 83, of $710,376, which is the difference between the premiums paid on their behalf and the $131,969 amount reimbursed by the taxpayers. The Tax Court rejected the argument that there was a sale of mere contract rights at fair value. No penalties were assessed, the court acknowledging the complex nature of the transaction and the reliance by the taxpayers on professional advisers.

With the new regulations, fewer taxpayers have split dollar arrangements. Many arrangements entered into on or before Sept. 17, 2003 took advantage of generous transition rules provided in Notice 2002-8. Those that did not are now examining their arrangements and considering various alternatives. This case highlights the IRS position that termination of an arrangement can result in current income.

NOTE

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte, its affiliates and related entities, shall not be responsible for any loss sustained by any person who relies on this publication.

Copyright © 2012 Deloitte Development LLC. All rights reserved.