Special Reports

Time to Simplify the Life-Nonlife Rules?

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The IRS recently added another layer of complexity onto the maze of "life-nonlife" rules found in Treas. Reg. section 1.1502-47, which are applicable to consolidated groups that include both life insurance companies and other corporations. In LTR 200252070 (Sept. 20, 2002) (the "Ruling"), *Doc 2003-70 (6 original pages), 2002 TNT 250-56*, the IRS ruled that net operating losses ("NOLs") carried over in a tax-free liquidation subject to section 381(a) from "ineligible" nonlife companies to an eligible life insurance company continue to be treated as ineligible NOLs which are subject to the separate return limitation year ("SRLY") restrictions as applied to the eligible life company's income. While this is a better result than eliminating the consolidated group's ability to use the NOLs altogether, it creates a knotty situation. The use of the NOLs, restricted by two separate regimes, is now dependent upon the income of *both* the eligible life insurance company and the income of the entire nonlife subgroup. Therefore, the Ruling underscores the need to simplify the life-nonlife rules.

Background

Life-nonlife groups confront restrictions imposed under section 1503(c) and the underlying life-nonlife regulations in Treas. Reg. section 1.1502-47. The myriad restrictions include: (i) the general rule that a life company cannot join the life-nonlife consolidated group until it has been owned by the group for five full taxable years; (ii) limitations on the use of nonlife NOLs against income of the life subgroup; and (iii) the requirement that losses of each subgroup must first be carried back against income of the same subgroup before offsetting income of the other subgroup.[1] Pursuant to section 1503(c), even if the nonlife NOLs are eligible and thereby available to absorb life income, they can only be used to the extent of 35% of the nonlife NOL or 35% of the life members' income, whichever is less.

[1] *See* Treas. Reg. section 1.1502-47(d)(12), (m) and (a)(2)(ii), respectively.

Facts of Ruling

In the Ruling (see chart on page 379), Parent owned all of the stock of Life 1 which owned all of the stock of Life 2 and of Life 3. Life 1 and Life 3 together owned all of the interests in Partnership. Partnership and Life 2 together owned all of the stock of Holding. Although not identified in the Ruling, Life 2 apparently owned less than 80 percent of the Holding stock. Holding owned all of the stock of Nonlife 4 and of Life 5; Life 5 owned all of Life 6. There were two life-nonlife group elections under section 1504(c)(2) in place, one for the group headed by Parent and one for the group headed by Holding. Holding and the corporations in the Holding group could not be included in the Parent group because at least 80 percent of the stock of Holding was not owned directly by one or more members of the Parent group.

On Date 1, Life 1 transferred its interest in Partnership to Life 3, which terminated the Partnership. Life 3 transferred the Holding stock to Life 2, thereby making Life 2 the sole shareholder of Holding. As a result, Holding and Nonlife 4 became includible but ineligible nonlife members of the Parent life-nonlife group. Treas. Reg. section 1.1502-47(d)(12). The Ruling identifies a "Date 2" which apparently is the date when Life 2 became the sole stockholder of Holding. On Date 3, Life 3 distributed to Life 1 the Holding stock received when Life 3 transferred the Holding stock to Life 2. On Date 4, Holding liquidated into Life 2 followed by Nonlife 4 liquidating into Life 2. (Between Dates 2 and 4, Life 5 and Life 6 elected to file a life-life consolidated return.) Both liquidations into Life 2 were nonrecognition transactions under sections 332, 337 and 381. Thereafter, Life 5 merged into Life 2 (but that merger does not impact the more interesting issues).

SRLY Restrictions Carry Over

The IRS held that the NOLs of Holding and Nonlife 4 arising before Date 2 were SRLY nonlife losses with respect to the Parent life-nonlife group because the losses arose in taxable years when the companies were members of another consolidated group, i.e., in the Holding life-nonlife group.[2] In general, the SRLY restrictions continue to apply if the

[2] Treas. Reg. section 1.1502-1(f)(1) provides that the term SRLY means any separate return year of a member or of a predecessor of a member. A separate return year is defined in Treas. Reg. section 1.1502-1(e) 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.

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NOLs are transferred pursuant to section 381 to another member of a consolidated group under the successor and predecessor rules.[3]

What is interesting is that the IRS also ruled that all of the operations of Life 2 will be taken into account in applying the SRLY limitation to the NOLs of Holding and Nonlife 4. Thus, Life 2's net positive income from all operations will be taken into account in applying the SRLY limitation because Life 2 is a successor to the two companies that generated the NOLs. This approach is consistent with the general SRLY rules, and is probably the correct way for the IRS to rule under the existing regulations.[4] Consequently, even though this holding results in the peculiar situation where the use of the SRLY nonlife NOLs is dependent on a life company's total income, before being subjected to the limits on using ineligible nonlife NOLs, it appears the appropriate answer given the general SRLY rules.

Taint of Ineligible NOLs Also Carries Over

The life-nonlife regulations do not contain rules to determine when an "ineligible NOL" remains in existence after a tax-free liquidation or merger. Nevertheless, the IRS concluded in the Ruling that the NOLs generated by Holding and Nonlife 4 before Date 4 (when both nonlife companies were liquidated into Life 2) continue to be treated as ineligible nonlife NOLs in Life 2 after their liquidations.[5] As a result, the ineligible NOLs cannot be utilized against income of the life subgroup. Furthermore, the IRS ruled that the ineligible NOLs incurred between Dates 2 and 4 could not be aggregated in determining the offsetable nonlife consolidated NOL, citing Treas. Reg. section 1.1502-47(m)(3)(vi).[6] While this approach favorably retains the availability of the ineligible NOL, albeit to a limited extent, it highlights the complexity of the life-nonlife regulations.[7]

In a perfect (or at least better) world, the IRS would have determined that the Holding and Nonlife 4 NOLs carry over to Life 2 without the ineligible nonlife taint. It is common tax planning to combine corporations or to contribute income-producing assets to increase a member's net positive income to assist in utilizing SRLY losses. Unlike the SRLY and section 382 regimes, the life-nonlife provisions do not have a predecessor-successor set of rules that *requires* the ineligible nonlife taint to carry over to Life 2. Assuming there was sufficient income to satisfy the SRLY limitations, treating the NOLs as eligible NOLs generally would have allowed the life members of the Parent consolidated group to offset the carried over losses against life subgroup income subject to the 35 percent limitations.

Another argument for eliminating the ineligible taint would be that section 381(c) simply carries over the losses to Life 2, without imposing this additional limitation, and thereby enables Life 2 to use the losses going forward. This argument is similar to the treatment of a merged ineligible nonlife company as eligible after the merger.[8] That is, subject to the life-nonlife regulations' restriction on disproportionate asset acquisitions in determining the five years of eligibility, shouldn't the merger or liquidation of an ineligible company into an eligible company merely make the combined company an eligible company which combines the tax attributes in the eligible company! When section 381 applies to the tax attributes of the transferor, the question of eligibility arguably should depend on the acquiring corporation's status.[9]

Under current law, the approach chosen by the IRS is a fair compromise between allowing a complete carryover without the ineligible nonlife taint and disallowing any carryover to Life 2 on the basis that section 844 is the exclusive provision for the treatment of NOLs in a life insurance company. That provision governs the use of operations losses generated by a life company when it becomes a property and casualty insurance company and the use of NOLs when a property and casualty insurer becomes a life

[3]Treas. Reg. section 1.1502-1(f)(4)(i) defines the term predecessor to mean a transferor or distributor of assets to a member (the successor) in a transaction to which section 381 applies. Treas. Reg. section 1.1502-21(f) provides that, for purposes of the SRLY rules, any reference to a corporation, member, common parent, or subsidiary, includes, as the context may require, a reference to a successor or predecessor, as defined in Treas. Reg. section 1.1502-1(f)(4).

[4]Under Treas. Reg. section 1.1502-21(f)(2), "Except as provided in paragraph (f)(2)(ii) of this section, if a successor's items or income and gain exceed the successor's items of deduction and loss (net positive income), then the net positive income attributable to the successor is excluded from the computation of the consolidated taxable income of a SRLY subgroup." However, Treas. Reg. section 1.1502-21(f)(2)(ii)(A) provides that a successor's net positive income is not excluded from the consolidated taxable income of a SRLY subgroup if the successor acquires substantially all of the assets and liabilities of its predecessor and the predecessor ceases to exist.

[5]Ruling paragraph (4) in the Ruling states that the NOL carryovers arising before Date 2 are ineligible nonlife losses which cannot offset life income, but are "offsetable against nonlife income of members of the Parent consolidated group subject to the restrictions of Treas. Reg. section 1.1502-47(m)(3)(ix)."

[6]Treas. Reg. section 1.1502-47(m)(3)(vi) provides that the offsetable nonlife consolidated NOL is the amount of the nonlife subgroup loss (generally computed under Treas. Reg. section 1.1502- 47(h)(2)(ii)) reduced by the "ineligible NOL." An ineligible NOL is in the year the loss arose the amount of the separate net operating loss of any nonlife member that is ineligible in that year.

[7]By not allowing aggregation of the NOLs carried over to Life 2, the Ruling may be consistent with Treas. Reg. section 1.1502-47(m)(3)(vi) but is inconsistent with the treatment of other corporations filing consolidated returns. Those other corporations are allowed to allocate losses among members on a pro-rata basis under Treas. Reg. section 1.1502-21(b). The effect of the life-nonlife unique treatment is to maximize the portion of the nonlife CNOL that is treated as an ineligible NOL and thus cannot be setoff against life subgroup income.

[8]Query whether losses of an ineligible *nonlife* company would retain their "ineligibility" after the merger into an eligible *nonlife* company, or a merger of an ineligible *life* company into an eligible *life* company.

[9]Even if the NOLs were eligible under Treas. Reg. section 1.1502-47 after a merger or liquidation, the limitations on noninsurance losses contained in section 806(b)(3)(C) might be cited to treat the NOLs as ineligible losses. Under that provision, the principles of section 1503(c) continue to apply to the use of noninsurance losses, presumably even if they are incurred or carried to a life insurance entity. However, the application of section 806(b)(3)(C) is quite uncertain and no guidance has been published.

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company.[10] On its face, section 844 does not apply to NOLs generated by a non-insurance company. Even if the liquidated companies had been property and casualty insurance companies that had generated the NOLs, section 844 might not apply because the liquidations into Life 2 are not changes in a tax status from nonlife *insurer* to life *insurer* (or vice versa), which is what section 844 covers. Furthermore, if section 844 does not apply to convert the NOLs into operations losses, section 805(b)(4) would technically prevent the life insurance company from using the NOLs in determining taxable income. Under that section, "Except as provided by section 844, the deduction for net operating losses provided in section 172 shall not be allowed."

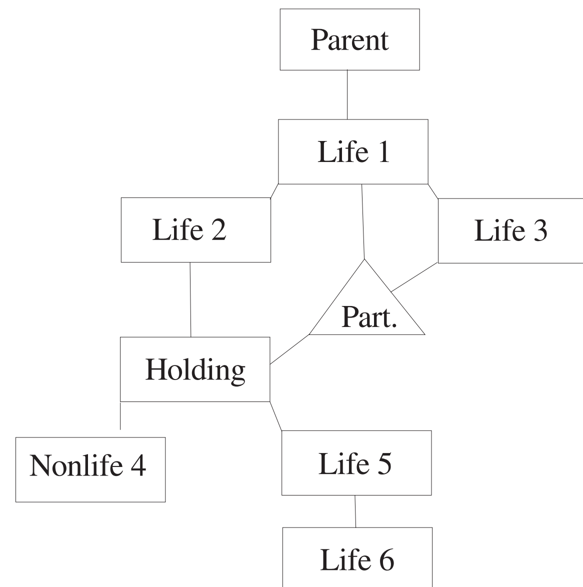
Prior Rulings on Ineligible Loss Carryovers

The Ruling is not the first time the IRS has held that ineligible nonlife NOLs retain their taint when transferred to a life company in a section 381 transaction. In LTR 9029030 (Apr. 20,1990), supplemented by LTR 9109012 (Nov. 27, 1990), a mutual life insurance company ("Mutual") was the common parent of the affiliated group that filed a life-nonlife consolidated return. It liquidated many nonlife subsidiaries that had generated NOLs during the time that the liquidated companies were members of Mutual's life-nonlife group (and, therefore, the losses did not become SRLYs). Because the liquidations were subject to section 381, the NOLs of the liquidated companies carried over to Mutual.

The IRS ruled that the NOLs will be available to offset life insurance company income but only by satisfaction of the life-nonlife restriction on the use of nonlife losses. Further, the 35 percent limitations would apply to the losss even though the losses have been carried over to Mutual. The IRS also ruled that the NOL carryover is not further limited by section 806(b)(3)(C) or denied by section 805(b)(4). Section 806(b)(3)(C) provides that in computing the life insurance company taxable income of a life insurance company, any loss from a *noninsurance business* will be limited under the life-nonlife principles of section 1503(c). Neither section 806(b)(3)(C) or 805(b)(4) have been considered often in the context of acquisitions. In fact, it appears that the section 806(b)(3)(C) directive to apply the life-nonlife limitations to noninsurance losses of a life insurance company has been cited only in the two rulings discussed herein. It certainly makes sense for the IRS to rule that this provision should not further limit the use of the NOLs carried to Life 2.

Furthermore, neither in the Ruling nor in LTR 9029030 had there been an ownership change within the meaning of section 382 that brought the liquidated companies into the Parent life-nonlife group. Section 382 was inapplicable becasue in both rulings the companies with the NOLs had

CHART



been owned indirectly by the same parties before and after the transactions. However, if the transaction had caused an ownership change subject to section 382, the determination of when the losses could be utilized would be further complicated because both the SRLY and section 382 loss restrictions apply to acquired life-nonlife groups (even though the SRLY limitation generally does not apply to "overlap" situations).[11]

Conclusion

Thus, as the careful reader can tell, the utter complexity of overlapping loss restrictions must be blamed on the existing and outdated life-nonlife rules. The insurance industry has consistently recommended changes be made to the existing law and regulations for some of the very reasons that this Ruling highlights.[12] Perhaps it is time for a change.

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[10]Life insurance companies are subject to taxation under Part I of subchapter L; other insurance companies are taxed under Part II thereof.

[11]Treas. Reg. section 1.1502-21(g) generally eliminates the SRLY limitation in an "overlap" situation when the ownership change type of acquisition of a consolidated group occurs within a 6-month period of the SRLY limitation and the SRLY loss subgroup is coextensive with the section 382 loss subgroup. The five-year waiting period for includibility of life companies means that all members of an acquired life-nonlife group will not join the acquiring group at the same time so that the acquisition fails the technical rules for coextensive groups.

[12]The American Council of Life Insurers (ACLI) requested changes to the life-nonlife regulations in lengthy comments filed on July 20, 2002 (*Doc 2002-18864 (31 original pages)* or *2002 TNT 158-21*). The submission highlighted the many provisions that are unduly complex and many times inconsistent with the treatment of consolidated returns generally. The ACLI noted that many of the provisions reflect policy decisions unwarranted by the statute and which are inappropriate because of the statutory changes in the taxation of life and nonlife insurance companies since promulgation of the life-nonlife regulations.

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