IRS PROPOSES SEPARATE ENTITY TREATMENT FOR A CELL

By Lori J. Jones and Janel C. Frank

On Sept. 14, 2010, the Internal Revenue Service (IRS) released proposed regulations that clarify that a single series[1] may be treated as an entity separate from a series organization for federal income tax purposes, even if it is not recognized as a separate entity under local law. The proposed regulations were issued, in part, to expand on Notice 2008-19, which requested comments for establishing when a cell of a cell company should be treated as an insurance company for federal income tax purposes. The proposed regulations apply more broadly to a series of a series limited liability company, a cell of a cell company, and a segregated account and portfolio of a segregated account company (except for segregated asset accounts of a life insurance company which are subject to special treatment under section 817). The proposed regulations do not apply to an individual cell that is organized under the laws of a foreign jurisdiction unless the cell is engaged in an insurance business. Under the proposed regulations, an individual cell will be treated as a separate entity for federal income tax purposes if the cell qualifies as an "insurance company" under the Internal Revenue Code. Significantly, the proposed regulations provide transitional relief for cells that were organized before Sept. 14, 2010, if certain factors are satisfied.

GENERAL RULES

In general, the proposed regulations recognize that the treatment of an entity separate from its owners for federal tax purposes is a matter of federal income tax law and not local law.[2] Consequently, an individual cell of a cell company is treated "as if" the cell were an entity formed under local law, even though the cell may not be recognized as a separate entity under the organizing state statute. Under the statutes of most states, the assets and liabilities of each individual cell must be segregated such that the debts and liabilities of one cell may not be enforced against assets of any other cell or against the cell company itself. Although segregation of assets and liabilities is required under most state statutes, the proposed regulations provide that the failure to segregate the assets and liabilities of an individual cell will not defeat treatment as a separate entity for federal income tax purposes. In fact, one cell may guarantee the debts and liabilities of another cell, without jeopardizing its treatment as a separate taxable entity.

APPLICATION TO INSURANCE CELL

According to the proposed regulations, treatment of an individual cell as a separate insurance company for federal income tax purposes depends upon federal tax law. Under section 7701(a)(3), an arrangement that qualifies as an insurance company must be treated as a corporation. Under sections 816(a) and 831(c), a company qualifies as an insurance company if more than half of the business engaged in during the taxable year is the issuing of insurance or annuity contracts or the reinsurance of risks underwritten by an insurance company. Consequently, under the proposed regulations, a cell whose business activity qualifies it as an insurance company under the Internal Revenue Code will be treated as a corporation and a separate taxable entity for federal income tax purposes.

UNANSWERED QUESTIONS

Unanswered questions include the treatment of an individual cell as an employer for employee benefits and employment tax purposes. Domestic statutes that authorize the creation of a cell indicate that a cell may operate a business that employs workers. In order to comply with employment tax regulations it would be necessary to determine whether the workers are employees and, if so, whether the cell or the cell company should be considered the employer for tax purposes. An employment relationship exists when "the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished."[3] The cell structure would make it difficult to determine whether the cell or the cell company is the employer. For example, if workers perform services under the direction and control of the cell, but are paid by the cell company (who is the nominal owner of the cell assets), query whether the cell or the cell company

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would be considered the employer under section 3401(d). The proposed regulations do not provide guidance on these issues.

Also, as set forth in Notice 2008-19, the IRS is expected to provide guidance on additional unresolved issues, including: 1) what transition rules may be appropriate or necessary for protected cell companies, or cells of such companies, if a protected cell company is not currently treated as a separate insurance company or if a cell of such a company qualifies as an insurance company for some taxable years but not for others; 2) what reporting, if any, would be necessary on the part of an individual cell to ensure that a protected cell company has the information needed to comply with section 3.02(c) of Notice 2008-19 (activities of a cell disregarded in determining the status of the protected cell company) and 3.02 (e) (protected cell company would not take into account any items of income, deduction, reserve or credit with respect to any cell that is treated as a separate insurance company); 3) whether different or special rules should apply with respect to foreign entities, including controlled foreign corporations; and 4) whether further guidance would be needed concerning the proper treatment of protected cell companies and their cells under the rules regarding consolidated returns. The IRS also requested comments on what guidance, if any, would be appropriate concerning similar segregated arrangements that do not involve insurance.

On the issue of consolidated returns, although an individual cell may be treated as a separate entity for federal income tax purposes, it remains unclear when the cell would be considered part of an affiliated group under section 1504. Under section 1504(a), an affiliated group includes one or more chains of includible corporations where the ownership of stock (without regard to "plain vanilla" nonvoting and nonconvertible preferred stock described in section 1504(a)(4)) satisfies the 80 percent vote and value test. If the business activities of the individual cell qualify it as an insurance company, the cell would be treated as a corporation but would only be considered part of an affiliated filing group if ownership of the "stock" in the cell satisfied the 80 percent vote and value test. Because individual cells are not treated as separate legal entities under state law, the ownership interests of the cell may not be specifically defined. Therefore, it is unclear how the 80 percent vote and value test would be satisfied for an entity that does not exist under state law.

The IRS has indicated that it intends to apply general principles to these matters.[4] As an example, the principal author of the proposed regulations has said that "the rule just puts taxpayers in the same position as if—instead of creating a series—they had just gone out and created a separate LLC. Our goal was to just equate those two situations."[5] Under current authority, the section 1504 vote and value test can be satisfied (in the absence of valid stock certificates) by considering the rights of the parties involved, including management rights, the right to participate in the profits, and the right to receive a share of the assets upon liquidation.[6] Furthermore, participation in the management through election of the board of directors generally is the criterion used by the courts and the IRS in determining voting power under section 1504(a).[7] As suggested by the IRS's recognition of the need for additional guidance, the application of general tax principles is not likely to be sufficient to fully address the unique treatment of cells as separate taxable entities.

Perhaps in anticipation of some of these unresolved issues, the proposed regulations provide rules that would require each cell and cell company to file an annual statement that includes the name, address, taxpayer identification number, jurisdiction of formation, and ownership details of any assets held by a cell or cell company.

TRANSITIONAL RULES

The regulations will be effective on the date that final regulations are published in the Federal Register unless the cell qualifies for relief under the transitional rule. Under the transitional rule, a cell established before Sept. 14, 2010, may continue to be treated together with other cells and/or with the cell company as one entity for tax purposes if 1) the cell was a domestic cell and conducted business or investment activity independent of its cell company; 2) the cell was a foreign cell and more than half of its business was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies; 3) no owner of the cell treats the cell as an entity separate from any other cell or the cell company for the filing of any federal income tax returns, information returns, or withholding documents; 4) the cell company had a reasonable basis for its claimed classification; and 5) neither the cell nor the cell company was notified prior to the date that final regulations are published in the Federal Register that the classification was under examination. The transitional rule will cease to apply upon certain ownership changes that result in the transfer of ownership in the cell or cell company of a 50 percent interest or more in the aggregate, to persons who were not owners prior to Sept. 14, 2010.[8] The preamble acknowledges that general tax principles will apply to deter-

mine the consequences of the conversion from one entity to multiple entities for federal tax purposes.[9] The application of these rules to insurance company cells can be uncertain. For example, if the transitional rule ceases to apply or does not apply when the regulations are effective, one question is how and when the general tax principles apply to the "deemed formation" of a new insurance company both for purposes of applying section 351 and the consolidated return rules as well as the provisions of Subchapter L.

CONCLUSION

The proposed regulations shed some light on the federal income tax treatment of series organizations and propose clear rules on treating a single cell as a separate insurance company (life or nonlife). It remains unclear, for consolidated return purposes, how the affiliation test will be satisfied. It is not clear who will be considered the owner of the cell and its assets when the cell is not treated as a separate entity. Additional guidance is likely to be necessary to clearly address these issues.

END NOTES

1. Note that, despite the fact that a series is defined in the dictionary as a number of items of similar classification being grouped together or in sequence, the regulations refer to a single item in the series organization as "a series." REG-119921-09. For purposes of this tidbit, the use of the term "cell" will mean collectively an individual series, cell, segregated account and segregated portfolio; and the term "cell company" will mean collectively a series organization, cell company or segregated account company.
2. Prop. Treas. Reg. § 301.7701-1(a)(5).
3. Treas. Reg. § 31.3121(d)-1(c)(2).
4. Elliott, *Highlights and Documents* at 7111 (Nov. 2, 2010) (discussing comments made by Dianna Miosi, special counsel, IRS Office of Associate Chief Counsel).
5. *Id.* (citing Joy Spies, attorney-advisor, IRS Office of Associate Chief Counsel).
6. *Himmel v. Commissioner*, 338 F.2d 815 (2d Cir. 1964); Rev. Rul. 69-591, 1969-2 C.B. 171.
7. *See Erie Lighting Co. v. Commissioner*, 93 F.2d, 883 (1st Circ. 1937), rev'g 35 B.T.A. 906 (1937); *Anderson-Clayton Securities Corporation*, 35 B.T.A. 795 (1937) and Rev. Rul. 69-126, 1969.1 C.B. 218.
8. Prop. Treas. Reg. § 301.7701-1(f)(3)(ii).
9. Treas. Reg. § 301.7701-3(g).

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