Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FSH:HAR:TL-N-2055-01
CJSantaniello

date: [illegible]

to: Patrick F. McGovern, Team Manager, LMSB, Group 1471, Waterbury, CT
Attn: Frank Del Vecchio, Team Coordinator

from: Associate Area Counsel, LMSB, Area 1

ject: Large Case Advisory Opinion - [redacted]

This memorandum responds to your request for assistance dated March 15, 2001. This memorandum should not be cited as precedent.

In your memorandum, you request our legal advice regarding the application of Rev. Proc. 99-44, 1999-2 C.B. 598 to the Business Owned Life Insurance (BOLI) issue in the taxpayer's taxable years [redacted] and [redacted]. For the reasons set forth below, Rev. Proc. 99-44 does not appear to provide any meaningful support for the taxpayer's position that the ruling is determinative of whether the taxpayer exercised sufficient control over the underlying assets associated with the insurance contracts to be treated as the owner of those assets for federal income tax purposes. Although the ruling expressly provides that it will "not be applied adversely to an issuer or holder of a contract issued before November 16, 1999", it does not supercede prior rulings or judicial precedent cited therein relating to the issue of investor control. The ruling merely provides two exceptions to the investor control doctrine relating to contracts intended to qualify as annuity contracts under sections 403(a) and 403(b) and individual retirement annuities under section 408(b), which may not apply to life insurance contracts.

Issue

Whether Rev. Proc. 99-44 is determinative of the issue of investor control regarding single premium, whole-life insurance policies purchased by the taxpayer on the lives of its employees.
U.I.L. No. 7805.01-01

Facts

During the examination of the taxpayer's [redacted] and [redacted] Forms 1120, the examination team identified a potential BOLI issue in those years. During a recent meeting, the taxpayer asserted that, as set forth in Rev. Proc. 99-44, the ruling may not be applied adversely to a BOLI issue if the taxpayer is the holder of a contract issued before November 16, 1999. From this, the taxpayer apparently concludes that even though it exercised significant

control over the underlying investments associated with the insurance contracts,[1] it should not be treated as the owner of those assets for federal income tax purposes.

The examination team has only recently begun the necessary factual development of the BOLI issue. Based upon the limited information obtained to date, it appears that the taxpayer purchased single premium, whole-life insurance policies with varying death benefits on the lives of approximately [redacted] of its employees. There is no direct benefit to the employees under this arrangement, as the taxpayer is the named beneficiary of each policy. The funds used to pay the premiums on the policies appear to consist of cash that would otherwise be available for investment by the taxpayer in passive investments, such as stocks, bonds, or other securities.

As each insured employee dies, the taxpayer receives the respective policy proceeds tax free under section 101(a). Under this arrangement, the taxpayer receives the gain (i.e., the cash buildup), which would be otherwise taxable if the taxpayer received it from the purchase and sale of assets. Furthermore, under the Code, the annual earnings on the investments (the cash build-up) are not taxed. Thus, the BOLI plan enables the taxpayer to convert what would otherwise be taxable investment income into tax free insurance proceeds.

On its [redacted] and [redacted] Forms 1120, the taxpayer reported the annual earnings on the assets associated with the insurance contracts of approximately $[redacted] for book purposes. On its [redacted] return, the taxpayer made a Schedule M adjustment, backing out those earnings for tax purposes. Apparently, however, the taxpayer forgot to make a similar adjustment for [redacted].

Discussion

Through its BOLI program, the taxpayer has attempted to take advantage of the special treatment afforded to life insurance contracts by the Code. There is no provision in the law that prevents a corporation from acquiring insurance contracts on the

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[1] The taxpayer has, however, previously stated that it did control the investments associated with the insurance contracts by directing the insurance company as to which of [redacted] separate mutual funds the insurance company should invest in. It appears that the insurance company could invest in no more than [redacted] mutual contracts at any one time. Further factual development regarding this control is necessary.

lives of its employees.[2/] Furthermore, as long as the arrangement qualifies as a "life insurance contract" under the provisions of section 7702, the policyholder will not be taxed on either the cash build-up or the policy proceeds. According to the taxpayer, they have fully complied with the Code and, therefore, need not include the build-up in its gross income.

The tax treatment of life insurance contracts is not, however, without limitation. For example, section 264(a) provides that no deduction shall be allowed for premiums paid on any life insurance policy if the taxpayer is directly or indirectly a beneficiary under the policy. Furthermore, the case law and rulings relating to annuity contracts provide that if the contract holder retains control over the underlying assets associated with the contract, the contract holder shall be treated as the owner of those assets for federal income taxes. See e.g, Christofferson v. United States, 749 F.2d 513 (8th Cir. 1984); Rev. Rul 82-55, 1982-1 C.B. 12; Rev. Rul 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev Rul. 77-85, 1977-1 C.B. 12. Thus, if the investor control doctrine is applied to the taxpayer's BOLI program, the taxpayer may be deemed to be the owner of the underlying assets, and, therefore, taxable on the cash build-up.

In Rev. Proc. 99-44, promulgated on November 16, 1999, the Service set forth circumstances under which it will treat a contract as an annuity contract described in sections 403(a), 403(b), or 408(b), notwithstanding that contract premiums are invested at the direction of the contract holder in publicly available securities. The ruling also includes a summary of investor control revenue rulings and case law as applied to "wraparound annuity contracts". Rev. Proc. 99-44 does not expressly apply to life insurance contracts, although the rulings and the case cited therein relating to the issue of investor control do have potential application to a BOLI plan.

Section 7805(b) explicitly authorizes the Treasury and the Service to "prescribe the extent, if any, to which any ruling or regulation, relative to the internal revenue laws, shall be applied without retroactive affect." In other words, the Treasury and the Service have the discretion to apply a regulation prospectively, but absent an exercise of that discretion, a regulation ordinarily has retroactive effect.

[2/] Although section 72(u) provides that if an annuity contract is held by a person who is not a natural person, the income on the contract shall be treated as the income of the owner of the policy, its provisions do not extend to insurance contracts.

In this case, the Service has exercised its discretion to apply Rev. Proc. 99-44 prospectively under the authority of I.R.C. § 7805(b). Specifically, Rev. Proc. 99-44 provides that "[t]his revenue procedure is effective on November 16, 1999, with respect to all taxable years." It further specifies that "under the authority of § 7805(b) of the Code, this revenue procedure will not be applied adversely to an issuer or holder of a contract issued before November 16, 1999." Thus, if the conditions set forth in Section 4 of Rev. Proc. 99-44 are satisfied, the Service will not treat the holder of a contract of the type specified in section 3 entered into before that date as owning the assets associated with the contract.

Because the safe harbor provisions of Rev. Proc. 99-44 do not apply to insurance contracts, the issue regarding its effective date in the context of BOLI issue is irrelevant. Consequently, the issue of investor control remains a viable legal theory that should be fully explored in this case. We, therefore, recommend that you continue to develop the facts relating to the taxpayer's BOLI plan and coordinate this case with the BOLI TA.

We are simultaneously submitting this memorandum to the National Office for post-review and any guidance they may deem appropriate. Consequently, you should not take any action based on the advice contained herein during the 10-day review period. We will inform you of any modification or suggestions, and, if necessary, we will send you a supplemental memorandum incorporating any such recommendation.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

Since there is no further action required by this office, we will close our file in this matter ten days from the issuance of this memorandum or upon our receipt of written advice from the National Office, whichever occurs later. Please call Carmino J. Santaniello at (860) 290-4075 if you have any questions or require further assistance.

BRADFORD A. JOHNSON
Associate Area Counsel
LMSB, Area 1

By: _____
CARMINO J. SANTANIELLO
Attorney