Internal Revenue Service

Index Number: 162.00-00

Number: **200035009**
Release Date: 9/1/2000

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:IT&A:5 PLR-121070-98
Date:

May 31, 2000

Company =

Trustee =

Insurer =

Plan =

Date 1 =

Date 2 =

Date 3 =

x =

Dear

This is in response to a request for rulings dated June 26, 1998, and subsequent correspondence, submitted on behalf of the Company by its authorized representatives. Rulings are requested regarding the income tax consequences relating to the exercise of participation options as more fully described below. The Internal Revenue Service addressed the first requested ruling in a ruling dated October 27, 1998 (PLR-113381-98, PLR 199905003). The second requested ruling is addressed herein.

The Company is primarily engaged in the business of certain manufacturing activities. It is the common parent of an affiliated group of corporations that files a consolidated federal income tax return on a calendar year basis using an accrual method of accounting.

Effective Date 1, the Company established an unfunded, nonqualified deferred compensation plan (the “Plan”) to provide benefits to certain Company executives (the “Participants”). Effective Date 2, the Company entered into a trust agreement with the

Trustee, an unrelated financial institution, which generally provided for the payment of benefits to the Participants or their beneficiaries as required under the Plan.

The Company subsequently determined to modify the Plan and provide the Participants with a choice between (i) a cash payment, or (ii) a direct and guaranteed right to fixed benefit payments under two group annuity contracts (the “Contracts”) purchased from the Insurer. It is represented that the Insurer determined the purchase price for the Contracts, $x, solely by applying its actuarial and pricing assumptions to the benefits and interests each Participant would have in the Contracts, and that the participation options did not effect the purchase price of the Contracts. The Company remitted the $x purchase price to the Insurer on Date 3.

Each Participant electing to receive benefits under the Contracts received a certificate of beneficial ownership in the Contracts that (1) specifies and fixes the benefits that each Participant is entitled to receive; (2) obligates the Insurer to pay the benefits to the Participant; and (3) creates for the Participant a direct and enforceable contractual right against the Insurer for payment of the benefits. A Participant’s rights under the Contracts are not forfeitable under any circumstances and are fully guaranteed by the Insurer.

In a ruling dated December 9, 1996 (PLR-75389-96, PLR 9713006), the Service determined that as a result of the modification of the Plan (a) the purchase price for the benefits under the Contracts allocable to each Participant is includible in the Participant’s income in the year the Contracts were purchased, and (b) the purchase price was deductible by the Company in that year under § 404(a)(5) of the Internal Revenue Code.

The assets supporting the Contracts are placed by the Insurer in one or more segregated asset accounts. The investment performance of those segregated asset accounts does not effect the amount or timing of benefit payments due Participants under the Contracts. The Contracts are unallocated, *i.e.*, all assets are available to satisfy all liabilities under the Contracts, and no assets are earmarked to provide benefits to a particular Participant.

The Contracts as issued were nonparticipating contracts, *i.e.*, only the Insurer was at risk, or stood to benefit, if the payment of benefits to the Participants differed from the actuarial and pricing assumptions the Insurer used to establish the purchase price of the Contracts. Both of the Contracts contain a participation option, which the Company timely exercised through the Trustee. After the participation options were exercised, the Company participates in the investment, mortality, retirement, and disability performance of the Contracts. Thus, if the assets in the segregated asset accounts available for payment of benefits under the Contracts fall below a specified minimum threshold, then the Company will be required to make a participation payment to the Insurer to restore the assets to the required level. Conversely, if those assets exceed the stated minimum threshold, the Company may, in accordance with the terms of the Contracts, require the Insurer to make a participation payment to the Company of the excess amount. It is represented that, after the participation options were exercised, there is no sharing of profits from investment assets between the Company and the Insurer, and that all of those profits inure solely to the Company. It is further represented that the participation arrangement resulting from the exercise of the options is wholly independent of the Insurer's obligations to the Participants, and in no way effects the rights and interests of the Participants under the Contracts. Whether or not the options are in effect, the Participants have nonforfeitable, fully guaranteed rights to the same benefit payments due from the Insurer.

After the participation options were exercised, the Company was required to notify the Insurer of the asset mix that it selected for investment of the assets supporting the Contracts. The Contracts provide for a choice of two asset mixes, and allow the Company and the Insurer to negotiate additional mixes. The Company may change the asset mix at any time, which would result in a corresponding change to the specified minimum threshold and may require a participation payment to or from the Company. It is represented, however, that the Company may not direct or control any specific investment asset purchased by the Insurer. The Company also may discontinue the participation arrangement at any time, which also may require a participation payment to or from the Company.

In response to the first requested ruling, the Service previously determined that neither the exercise of the participation options under the Contracts, nor participation payments from the Company to the Insurer, nor participation payments from the Insurer to the Company, will result in the current inclusion of any amount in income by the Participants, or their beneficiaries, under the Plan. The second requested ruling is that "The Company must recognize in gross income any participation payments received from the Insurer and may deduct from gross income any participation payments to the Insurer."

The exercise of the participation options raises a threshold issue as to whether the resulting participation arrangement between the Company and the Insurer constitutes a separate entity for federal income tax purposes. The creation of a separate entity would effect the proper tax treatment of payments between the two parties.

Section 7701(a)(2) of the Code provides that the term partnership includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation, trust or estate. Section 301.7701-1(a)(1) of the Procedure and Administration Regulations provides that the Internal Revenue Code prescribes the classification of various organizations for federal income tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Section 301.7701-1(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and, in addition, provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner or tenants in common of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

Section 301.7701-1(b) provides that the classification of organizations that are recognized as separate entities is determined under §§ 301.7701-2, 301.7701-3, and 301.7701-4 unless a provision of the Code provides for special treatment of that organization.

Case law principles concerning whether a partnership exists provide some guidance on whether a separate entity is created for federal tax purposes. Under the case law, whether a partnership exists is determined by considering whether, in view of the parties' actions, the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. Commissioner v. Culbertson, 337 U.S. 733 (1949), 1949-2 C.B. 5. A list of factors to be considered, none of which is conclusive, is set forth in Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964):

> The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party had made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed federal partnership returns

> or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

The determination of whether parties intended to join together in a partnership "is a question of fact to be determined from testimony disclosed by their agreement, considered as a whole, and by their conduct in execution of its provisions." Commissioner v. Tower, 327 U.S. 280, 286-87 (1946). The best evidence of the intent of parties is any written document signed by the parties that defines their relationship.

The documents submitted with this ruling request make no reference to a partnership between the Company and the Insurer, and neither party represents to the Service or third parties that there is a partnership arrangement. Although the Company may select the general asset mix of the assets supporting the Contracts, it will not direct or control any specific asset purchased by the Insurer. Finally, the Company and the Insurer do not share in the profits and losses associated with the Contracts after the participating options were exercised. Accordingly, the conversion of the Contracts from nonparticipating to participating status by virtue of the Company exercising its participation options does not result in the formation of a separate entity for federal tax purposes.

Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during a taxable year in carrying on any trade or business. Under § 263(a), no deduction is allowed for any amount paid our for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

Under § 451, the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period. Pursuant to § 1.451-1(a), income is includible in gross income under an accrual method of accounting when all the events have occurred that fix the right to the income and the amount thereof can be determined with reasonable accuracy.

Under § 461, the amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income. Pursuant to § 461(h) and § 1.461-1(a)(2), a liability is incurred under an accrual method of accounting, and generally is taken into account for federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

The Supreme Court in Commissioner v. Lincoln Savings and Loan Association, 403 U.S. 345 (1971), addressed whether payment of required premiums to a secondary reserve fund established by the Federal Savings and Loan Insurance Corporation to cover losses if other accounts proved insufficient were deductible business expenses or nondeductible capital expenditures. The Court relied on several factors in concluding that the premiums were capital expenditures, including the fact that, under certain circumstances, the premiums were refundable to the savings and loan association.

In Rev. Rul. 83-66, 1983-1 C.B. 43, the taxpayer obtained medical malpractice insurance that contained a retrospective rate credit refund provision under which the taxpayer could receive a refund of a portion of the premiums paid if the insurer's loss experience over a five year period was not as great as projected. The ruling concludes that there was sufficient risk shifting to constitute insurance, and thus the premiums are deductible as ordinary and necessary business expenses under § 162 unless they are required to be capitalized under § 263(a). The ruling then distinguishes Lincoln Savings and Loan Association, supra, stating that "[t]he mere expectancy that a refund may be forthcoming in a future tax year because malpractice claims actually incurred for a policy year are less than originally expected does not create an asset in the hands of the taxpayer paying the premium."

Similarly, any participation payments the Company may make in this case are not required to be capitalized under § 263(a). The mere expectancy that the actual experience under the Contracts will deviate favorably from the actuarial and pricing assumptions used in pricing the Contracts, and thus potentially result in a right to subsequent participation payments from the Insurer, does not create a separate and distinct asset in the hands of the Company.

Accordingly, based on the facts and representations submitted with the ruling request, we conclude that the Company must recognize in gross income any participation payment from the Insurer in the taxable year in which the right to the payment becomes fixed and the amount thereof is reasonably ascertainable. In addition, the Company may deduct from gross income as an ordinary and necessary business expense under § 162(a) any participation payment made to the Insurer in the taxable year in which the payment is made.

No opinion is expressed as to the tax treatment of the exercise of the participation options under the provisions of any of the other sections of the Code and regulations which may be applicable. In addition, no opinion was requested and none is expressed as to the applicability of § 72(u) of the Code to the Contracts in the hands of the Company.

In accordance with a power of attorney filed in connection with this ruling request, a copy of this ruling is being sent to your authorized representative. A copy of this ruling should be attached to any federal income tax return to which it is relevant.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,
Acting Assistant Chief Counsel
(Income Tax and Accounting)
By: Douglas A. Fahey
Acting Chief, CC:DOM:IT&A:5