INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-150991-03 CC:FIP:B04

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

Holding =

X =

Y =

Year-1 =

Year-2 =

L-1 =

L-2 =
L-3 =

.

Partnership-1 =

$300x =

ISSUE:

Whether Taxpayer is entitled to gross up the interest deduction with respect to certain acquisition indebtedness flowing from Partnership-1, pursuant to section 217(k) of the Deficit Reduction Act of 1984, as revised by section 1011(c)(2) of the Tax Reform Act of 1986 (the “Huddleston amendment”)?

CONCLUSION(S):

Because Taxpayer satisfies the clear language of the Huddleston amendment, and because the acquisition indebtedness to which this narrow provision applies was not a sham, Taxpayer is entitled to gross up the interest deductions flowing from Partnership-1 for the years involved.

FACTS:

Taxpayer is a stock life insurance company taxed under section 801 of the Internal Revenue Code. For a number of years, Taxpayer had been an eligible member of a life-nonlife consolidated group under section 1504(c) (2) (A) of which Holding is the common parent. Taxpayer’s ultimate parent is X, a foreign corporation

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During Year-1, X acquired the

operations

of Y

in a transaction in which Y shareholders received X stock. Y conducted its

operations through multiple corporations, including a number of life insurance company subsidiaries. Because X was interested in retaining only Y’s life insurance operations, Y’s consumer finance operations were spun off to Y’s former shareholders, and ownership of Y’s life insurance subsidiaries and related service companies was transferred to Holding. In Year-2, as part of a plan to consolidate the acquired life insurance companies with its own insurance operations, Holding caused two of Y’s former life insurance company subsidiaries, L-1 and L-2, to merge into Taxpayer in a tax-free reorganization to which the provisions of sections 368 and 381 applied. Because this merger resulted in a disproportionate asset acquisition for purposes of the five-year affiliation requirement of section 1504(c) (2), Taxpayer ceased to be an eligible member of Holding's life-nonlife consolidated group and therefore filed separate returns for the years involved.

This technical advice request concerns Taxpayer's eligibility to claim the benefit of a grossed up interest deduction as the result of a special transition rule known as the Huddleston amendment. The Huddleston amendment was originally enacted as section 217(k) of the 1984 Act in connection with the special life insurance company deduction under former section 806(a). The Huddleston amendment was narrowly drawn to apply to a particular taxpayer in connection with a specific transaction.

On January 2, 1981, Y joined with two existing life insurance company subsidiaries, L-1 and L-2, to create an investment partnership, Partnership-1, for the purpose of acquiring a new life insurance company subsidiary (L-3). Y was the general partner, and L-1 and L-2 were limited partners. The purchase of L-3 stock was completed by Partnership-1 on January 14, 1981. To finance this acquisition, Y loaned Partnership-1 the sum of $300x dollars by means of a purchase money debenture due January 15, 2006. Interest was to be paid semiannually at a 14 percent rate, which was an arm's length rate when the debenture was issued.

One of the factors underlying the decision to structure the acquisition of the L-3 stock through an investment partnership using debt financing was to enable L-1 and L-2 to utilize the interest deductions related to the acquisition indebtedness. In the 1984 Act, however, Congress made substantial changes to the life insurance company tax provisions set forth in Part I of subchapter L. The changes included the enactment of the special life insurance company deduction of section 806(a), which reduced the effective tax rate for all life insurance companies on income from insurance business from 46 percent to 36.8 percent. Absent transition relief, the reduction of the effective tax rate would have reduced the tax benefits that L-1 and L-2 derived from their distributive share of Partnership-1's interest payments on the purchase money debenture used to finance the 1981 stock acquisition.

In order to preserve the anticipated tax benefits for L-1 and L-2, Senator Huddleston from Kentucky proposed a special rule which Congress enacted as section 217(k) of the 1984 Act. Under the Huddleston amendment, a life insurance company that acquired the stock of another corporation on January 14, 1981 through a partnership using debt financing was allowed to exclude the interest deductions related to this stock acquisition when determining the amount of the company's special deduction under section 806(a). This had the effect of grossing up the life insurance company's related interest deduction such that the interest payments continued to provide a tax benefit at a 46 percent effective rate.

When the 1986 Act reduced the corporate tax rates generally from 46 percent to 34 percent, Congress repealed the special life insurance company deduction on the theory that it was no longer needed. At the same time, Congress amended 1984 Act section 217(k) to ensure that the tax benefit allowed L-1 and L-2 under the provision with respect to the interest deductions stemming from the 1981 stock acquisition was not reduced in post-1986 tax years. Under the 1986 Act amendments to 1984 Act section 217(k), a life insurance company that met the requirements of the Huddleston amendment with respect to the January 14, 1981 stock acquisition was allowed to gross up all items of income, gain, loss, or deduction attributable to the ownership of such stock by 125 percent in computing taxable income which, under section 801(b), was LICTI in the case of a life insurance company.

As a result of the merger of L-1 and L-2 into Taxpayer, Taxpayer acquired the partnership interests held by L-1 and L-2 in Partnership-1. This transfer of these partnership interests to Taxpayer did not result in the termination of Partnership-1. For the years involved, Partnership-1 filed returns on Form 1065 reporting substantial excess deductions primarily arising from interest deductions related to the 1981 stock acquisition. Under section 702(a) (7), Taxpayer was required to take into account its distributive share of Partnership-1's interest expense as a pass-through item. Based on the Huddleston amendment, Taxpayer grossed up the interest expense (and certain income items) flowing from Partnership-1 by 125 percent in computing LICTI on its separate return for the years involved.

On examining Taxpayer's returns for the years involved, the examining agent proposed to eliminate the 125 percent gross up claimed by Taxpayer with respect to the interest deduction flowing from Partnership-1. The examining agent argues that the Huddleston amendment should be strictly construed to apply only to a life insurance company that was an intended beneficiary of this special interest legislation. Under the agent's view, allowing Taxpayer to claim a grossed up interest deduction as a result of X's acquisition of the Y group of life insurance companies, and the subsequent merger of L-1 and L-2 into Taxpayer, would effectively treat the benefits of the Huddleston amendment as "freely alienable property rights transferable among taxpayers." The examining agent also maintains that, in the hands of Taxpayer, the grossed up interest deduction stemming from the January 14, 1981 acquisition was essentially a sham because the interest payments were made to related parties, and because the 14 percent rate on the purchase money debenture was excessive relative to current interest rates.

Taxpayer's position is that it satisfies all of the requirements for relief under the Huddleston amendment and, therefore, was entitled to gross up the interest expense flowing from Partnership-1 by 125 percent in computing its taxable income for the years involved. For reasons stated below, we agree with Taxpayer.

LAW AND ANALYSIS

The Deficit Reduction Act of 1984, P.L. 98-369, amended the life insurance company taxation provisions for taxable years after 1983, by repealing prior law Part I of subchapter L, sections 801 through 819A, and replacing these provisions with a totally revised, comprehensive system of taxing life insurance companies. The basic framework for life insurance company taxation was adopted by Section 211 of the 1984 Act, and was incorporated in substantial part into the Internal Revenue Code as Subchapter L, Part 1, sections 801 through 818.

Under the revised provisions of Part I of subchapter L, a life insurance company is taxed at the generally applicable corporate rates on its "life insurance company taxable income" (LICTI), which is defined in section 801(b) as life insurance gross income reduced by life insurance deductions.

For taxable years after 1983, but before 1987, section 804 provided that "life insurance deductions" consisted of the general deductions provided in section 805, the special life insurance company deduction provided in section 806(a), and the small life insurance company deduction, if any, determined under section 806(b). The special life insurance company deduction and the small life insurance company deduction were collectively referred to in section 806 as "special deductions."

Section 806(a) provided that the special deduction for any taxable year was 20 percent of "tentative LICTI" for such taxable year over the small life insurance company deduction, if any provided, in section 806(b). " Section 806(b) provided that the small life insurance company deduction was 60 percent of tentative LICTI in excess of $3 million, phasing out entirely when tentative LICTI equaled or exceeded $15 million. Section 806(b)(3) provided that the small life insurance company deduction was not available to life insurance companies with assets of $500 million or more (determined on a controlled group basis). Under section 806(c), the term "tentative LICTI" was defined as LICTI determined without regard to the special life insurance company deduction, the small life insurance company deduction, and items attributable to noninsurance business.

The special life insurance company deduction under section 806(a) was enacted as part of the 1984 Act, based on a congressional concern that the comprehensive revision to the life insurance company tax rules could cause a sudden and substantial

increase in the life insurance industry's tax burden. Because the special life insurance company deduction was available to any insurance company, and did not require the setting up of a reserve or expense item on the company's books, the effect of this provision was to reduce the highest tax rate for life insurance companies on income from insurance business from 46 percent to 36.8 percent.
The provision at issue in this case was a transition rule originally enacted in section 217(k) of the 1984 Act in connection with the special life insurance company deductions under section 806. Section 217(k) provided as follows:

> (k) SPECIAL RULE FOR CERTAIN DEBT-FINANCED ACQUISITION OF STOCK. –If-
>
> (1) a life insurance company owns the stock of corporation through a partnership of which it is a partner,
>
> (2) the stock of the corporation was acquired on January 14, 1981, and
>
> (3) such stock was acquired by debt financing,
>
> then, for purposes of determining the special deductions under section 806 of the Internal Revenue Code of 1954 (as amended by this subtitle), the amount of tentative LICTI of any qualified life insurance company shall be computed without taking into account any income, gain, loss, or deduction attributable to the ownership of such stock.

This provision originated in the Senate's consideration of H.R. 2163, as an amendment relating to the special life insurance company deduction provision proposed by Senator Huddleston of Kentucky. In discussions of the amendment on the Senate floor, Senator Huddleston characterized the amendment as "very narrowly drawn … to deal with a specific situation that occurred during a transition period in 1981 relating to the interpretation of insurance and noninsurance business." Senator Dole, the chairman of the Senate Finance Committee, stated that the amendment would cost $4 million dollars a year, and "solves a transition problem for a company that in 1981 took the unusual step of acquiring a life insurance company using borrowed funds rather than investing their policyholder's funds." 130 Cong. Rec. S4454, S4644-45 (1984).

The special life insurance company deduction under section 806(a) was repealed by the 1986 Act. According to the 1986 Act legislative committee reports, Congress concluded that the special life insurance company deduction was no longer necessary because of the changes being made by the Act to the general corporate rates, which reduced the highest corporate tax rate from 46 percent to 34 percent. As a result of the repeal of the special life insurance company deduction, section 806(b), relating to the small life insurance company deduction, was recodified as section 806(a), and Section 806(c), defining tentative LICTI, was recodified section 806(b).

Section 1011(c) (1) of the 1986 Act provided that the repeal of the special life insurance company deduction was effective for taxable years beginning after December 31, 1986. Section 1011(c) (2) of the 1986 Act amended section 217(k) of the 1984 Act as follows:

> (k) SPECIAL RULE FOR CERTAIN DEBT-FINANCED ACQUISITION OF STOCK. –If-
>
> (1) a life insurance company owns the stock of corporation through a partnership of which it is a partner,
>
> (2) the stock of the corporation was acquired on January 14, 1981, and
>
> (3) such stock was acquired by debt financing,
>
> then, for purposes of determining the small life insurance company deductions under section 806(a) of the Internal Revenue Code of 1954 (as amended by this subtitle), the amount of tentative LICTI of such life insurance company shall be computed without taking into account any income, gain, loss, or deduction attributable to the ownership of such stock. For purposes of determining taxable income, the amount of any income, gain, loss, or deduction attributable to the ownership of such stock shall be an amount equal to 46 times the amount of such income, gain, loss, or deduction, dividend by 36.8.

The 1986 Act legislative committee reports describe the intent underlying the amendment to 1984 Act section 217(k) as follows:

> A special rule is provided in the case of a life insurance company owning the stock of another corporation through a partnership, which stock was acquired on January 14, 1981. For purposes of determining the small life insurance company deduction under section 806(a), tentative life insurance company taxable income is computed without taking into account income, gain, loss or deduction attributable to the ownership of such stock, and the amount of such income, gain, loss, or deduction is taken into account at the rate of 46/36.8, which provides the same tax benefit to the life insurance company as provided under present law.

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-344 (1986)

The background of the Huddleston amendment indicates that Congress designed this provision to apply narrowly, with the benefits targeted for Y's life insurance subsidiaries in connection with a specific stock acquisition. Although the examining agent argues that X's acquisition of Y's insurance operations, and the subsequent merger of L-1 and L-2 into Taxpayer, should result in the termination of the benefits of the Huddleston amendment, there is nothing in the language of the statute to cause this result. As a result of this merger, Taxpayer acquired the interests which L-1 and L-2 held in Partnership-1, and therefore also succeeded to the tax benefits allowed by the Huddleston amendment as regards the interest deductions flowing from Partnership-1 with respect to the indebtedness incurred in connection with the January 14, 1981 stock acquisition. Taxpayer was a life insurance company that owned the stock of another corporation (L-3) through a partnership (Partnership-1) of which Taxpayer was a partner; the stock of L-3 was acquired on January 14, 1981; and Partnership-1 acquired the stock of L-3 with funds obtained through its issuance of a purchase money debenture to Y, and this acquisition indebtedness was still outstanding during the years involved. Accordingly, we believe that Taxpayer satisfied the clear language of 1984 Act section 217(k), as amended in 1986.

We also do not believe that the current facts justify the application of a sham analysis to disregard the gross up of Taxpayer's interest deduction flowing from Partnership-1 as a result of the Huddleston amendment. In applying a sham analysis, courts have distinguished "shams in fact," where the purported transactions never occurred, and "shams in substance," where the transactions actually occurred but lack the substance that their form represents. ACM Partnership v. Commissioner, 157 F.3d 231, 247 n. 30 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (2002) (citations omitted). In determining whether a transaction constitutes a sham in substance, both a majority of the Courts of Appeals and the Tax Court consider two related factors, economic substance apart from tax consequences, and business purpose. See ACM Partnership; Karr v. Commissioner, 924 F.2d 1018, 1023 (11th Cir. 1991), cert, denied, 502 U.S. 1082 (1992); James v. Commissioner, 899 F. 2d 905, 908-09 (1oth Cir. 1990); Shriver v. Commissioner, 899 F. 2d 724, 727 (8th cir. 1990); Rose v. Commissioner, 868 F. 2d 851, 853 (6th Cir. 1989); Kirchman v. Commissioner, 862 F.2d 1486, 1492 (11th Cir. 1989).

In the instant case, the purchase money debenture with respect to which Taxpayer has claimed a grossed up interest deduction was not a sham in fact. Funds were actually borrowed and used to finance the acquisition of L-3. Nor was the purchase money debenture a sham in substance. The debt was incurred for a business purpose (i.e., the acquisition of L-3 stock); the 14 percent interest rate was a market rate when the debt was issued; and Partnership-1 made all of the semi-annual interest payments required by the terms of the purchase money debenture. We do not believe the fact that these interest payments are now made by Partnership-1 to a related party is sufficient grounds to treat the acquisition indebtedness as lacking economic substance. The tax rules regarding the consistent reporting of related party interest implicitly recognize that a valid indebtedness may exist between related parties. See, e.g., section 267(a)(2); Treas. Reg. section 1.1502-13(g)(5), Example 1. Accordingly, Taxpayer is allowed to gross up the interest deductions flowing from Partnership-1 by 125 percent in computing income. This result is specifically authorized by the

Huddleston amendment, and therefore does not violate the general tax rules regarding the consistent reporting of related party interest.

CAVEATS

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.