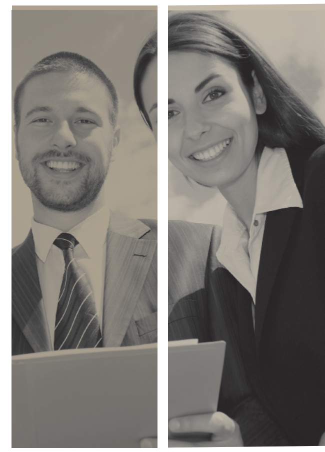
SOCIETY OF ACTUARIES Taxation Section

Taxing TIMES

VOLUME 7 | ISSUE 1 | FEBRUARY 2011



Congress Clarifies Treatment of Partial Annuitizations

*By Bryan W. Keene**

Congress recently provided helpful clarification of the tax treatment of non-qualified deferred annuities that are "partially" annuitized. The clarification, enacted this fall as part of the Small Business Jobs Act,[1] essentially treats partial annuitizations the same way that full annuitizations are treated under current law, provided that certain conditions are met. The result is that payments from a compliant partial annuitization will be taxed using an exclusion ratio, thereby allowing the owner to recover basis *pro rata* over the payment term, rather than taxed using the income-first ordering rule that applies to withdrawals and other non-annuity payments.

Treasury Department and Internal Revenue Service (IRS) officials had previously questioned whether this result could be achieved technically under existing IRS regulations, despite more than a decade of insurance industry advocacy that it could. Ultimately, Congress stepped in, eliminated the technical hurdles, and facilitated partial annuitization in the interest of encouraging Americans to annuitize their retirement savings. The fact that the provision was projected to increase federal revenues by about $1 billion over the next 10 years almost certainly had a helping hand in its legislative fate. Given the government's need for more revenue, as well as the insurance industry's support for the provision and the absence of any constituency against it, the proposal became low-hanging fruit for Congress to pluck as a revenue raiser, while at the same time promoting an important tax policy goal.

The new law applies to partial annuitizations under life insurance contracts and endowment contracts, in addition to those under annuity contracts, but this article focuses on the latter. The article summarizes the new legislation and provides some background on how it

CONTINUED ON PAGE 6

VOLUME 7 | ISSUE 1 | FEBRUARY 2011

Taxing TIMES

FROM THE EDITOR
CIAO READERS!

By Brian G. King

Almost seven years and 21 issues (including supplements) ago, I had the pleasure of introducing *Taxing Times* in my first editorial column. This column marks my final as editor. Recently, I revisited that first column and our first issue of *Taxing Times*. It provided me with the opportunity to reflect back on our newsletter, and it made me realize just how far we have come.

From the beginning, the goal of *Taxing Times* was to provide a forum for discussion and the exchange of knowledge for issues concerning insurance taxation. From the humble 20-page beginnings of the first newsletter, we have grown in both size and stature. (I believe several issues have topped the 60-page mark.) We definitely met our goal of education, but our newsletter has gone beyond that. Our publication has become an important and influential tool in the insurance tax community. We have been referenced and quoted by government personnel and immortalized in IRS Notice 2009-47. We have come a long way!

Through the years, our newsletter has developed, changed and evolved. The addition of standard columns such as the ACLI Update column has been a great enhancement to the publication. We also went through an SOA redesign that gave our newsletter a more modern appearance. Our editorial board was expanded and restructured to have new members roll on and existing members roll off in an effort to keep our board's perspective fresh and to broaden our knowledge reservoir.

I could not be more pleased with *Taxing Times'* success, and like a proud father, I take satisfaction in the fact that I was a part of its early years. Serving as your editor has been an extremely rewarding and gratifying (if occasionally taxing) experience. I would like to thank so many people that have been there along the way. Thanks to all the authors that have contributed to *Taxing Times* these past seven years. Your articles and insights provide the quality content that our newsletter is known for. I encourage you to continue with your contributions. I would also like to thank the outstanding editorial board, both past and present members, which I have had the pleasure of working with through the years. The knowledge, experience and objectivity of this group have served our newsletter well. I would also like to thank the Taxation Section Council and friends of council who have supported *Taxing Times* and participate in our thorough, and often quick, peer review process and our outstanding SOA newsletter support staff, Jacque Kirkwood and Julissa Sweeney (I know the volume is often substantial and you both do an amazing job in getting us to print). Finally, I would be remiss if I did not acknowledge the work of my assistant editor Christine Del Vaglio. Her efforts these past five years have been greatly appreciated and have contributed significantly to the success of our newsletter.

I leave *Taxing Times* in very capable hands with your new editor, Chris DesRochers. I would like to say that I taught him everything he knows, but the opposite of that may be slightly more accurate. His first official action of making me one of his newly assigned associate editors ensures that I will remain involved with the publication. Given that, I won't say goodbye to my readers, just ciao.

Enjoy the issue!

Brian G. King, FSA, MAAA, is a managing director, Insurance Actuarial Services with LECG and may be reached at *bking@lecg.com.*

NOTE FROM THE EDITOR

All of the articles that appear in *Taxing Times* are peer reviewed by our Editorial Board and Section Council members. These members represent a cross-functional team of professionals from the accounting, legal and actuarial disciplines. This peer-review process is a critical ingredient in maintaining and enhancing the quality and credibility of our section newsletter.

While this newsletter strives to provide accurate and authoritative information in the content of its articles, it does not constitute tax, legal or other advice from the publisher. It is recommended that professional services be retained for such advice. The publisher assumes no responsibility with assessing or advising the reader as to tax, legal or other consequences arising from the reader's particular situation.

Citations are required and found in our published articles, and follow standard protocol.

—Christian DesRochers

Christian DesRochers, FSA, MAAA, is a managing director, Insurance Actuarial Services with LECG and may be reached at *cdesrochers@lecg.com*.

FROM THE CHAIR

BUILDING ON OUR PAST SUCCESS

By Steven C. Chamberlin

This is my first column as section chair, and I'm honored to have the opportunity to lead this group. I'd like to thank Chris DesRochers for his excellent leadership over the past year. He leaves big shoes to fill, but I'm also confident that he won't stray too far away. This section has an active group of Friends of the Council, and I'm quite sure that Chris will continue to be a big supporter of this section.

We've had a lot of accomplishments in the past year and we'd like to build on that in the year ahead. Our section continues to be an active sponsor or co-sponsor of sessions at the Life and Annuity Symposium, Product Tax Seminar, Valuation Actuary Symposium and the SOA Annual Meeting. We have broadened our audience by reaching out to other sections and adding tax representatives to panels where appropriate, and we have also brought in Internal Revenue Service and Treasury Department representatives to speak at SOA programs.

If there were a prize for lengthiest section newsletter, ours would surely win. We've had an amazing selection of well-researched articles on timely tax topics. I'd also like to thank our authors, the Editorial Board and especially Editor Brian King and Associate Editor Christine Del Vaglio, who have worked extremely hard to make *Taxing Times* a high quality publication packed with important information.

Our April 2010 webinar on Notice 2010-29 drew a big audience to the timely topic of tax issues associated with Actuarial Guideline 43. The section will continue to look for opportunities to bring relevant information out quickly through webinars in 2011. Our Tax Reserve Seminar will be held March 24–25 in Orlando and is a great way for those with varying amounts of valuation experience to expand their knowledge of tax reserves. We hope you join us.

We value our affiliate members. Our section knows that it has been a challenge for affiliate members to pay their dues and maintain their membership, and we are working to improve that. I am quite interested in suggestions on how to expand our affiliate membership and how to serve it better.

We also welcome new members Ann Delaney, Carol Meyer and Mary Elizabeth Caramagno to the section council. The section functions best with input and participation from our section members. It's been said many times before, but you get back far more than what you put into it. There are many ways to get involved, and I'd encourage you to contact me or any council member if you:

- Have an idea for a topic for a meeting session or webinar,
- Are interested in being a speaker,
- Have an idea for an article in the section newsletter,
- Are interested in writing an article,
- Have an idea for research or surveys that the section could conduct or sponsor, or
- Have any other suggestions on how the section can serve you better.

I appreciate the hard work of those who founded this section in 2004 and built it into what it is today. I look forward to the challenge of leading this section for the next year, but I also remind all members that this is your section. Please don't hesitate to point us in the right direction and to get involved!

Steven C. Chamberlin, FSA, MAAA, is a consulting actuary with Chamberlin Consulting, LLC and may be reached at *scc_61_92@mediacombb.net.*


Get the news. Now it's easier.
New look!
SOCIETY OF ACTUARIES
soanews TODAY
Improved navigation!
in this issue
Making News
Inside the SOA
Spotlight on Sections
Knowledge Matters
Research Front
In Memory
A Category of Its Own
Member Poll
making news
Organized for an easy read!
Actuary Listed Best Career of 2011
FSA Stuart Klugman quoted in this article ab
profession.
Women Outlive Men, But Don't Plan for It
FSA Anna Rappaport is quoted in Reuters about the
of retirement on women. The article reports that half of
American women will live past age 85, but very few are
planning for it.
Back To Top
Coming to you from e-news@soa.org
soanews TODAY
e-newsletter

became law, including the technical obstacles that heretofore discouraged partial annuitizations of annuity contracts. The article also briefly discusses the relationship between the new partial annuitization rule and existing IRS guidance on partial exchanges of deferred annuity contracts.

WHY PARTIAL ANNUITIZATION?

The insurance industry and many economists have argued that public policy should encourage annuitization—especially lifetime annuitization—to provide a guaranteed stream of retirement income. The reasons for this are well known: individuals are living longer; defined benefit plan coverage is declining; pressure on Social Security is growing; and only a life annuity can assure that an individual's assets will provide income for the whole of life. The Treasury Department itself recently focused on the public policy benefits that annuitization can bring,[2] and identified the enactment of partial annuitization legislation as one possible means to promote it.[3]

A partial annuitization is a transaction in which the owner of a deferred annuity contract applies a portion of the contract's cash value to purchase a stream of annuity payments under the contract, while leaving the remaining cash value accessible within the contract. There are many reasons that an individual may wish to conduct such a transaction. For example, the person may wish to annuitize a portion of his or her cash value to cover basic ongoing living expenses like food and housing, while leaving the remaining cash value intact for future needs. Or a person may wish to "dollar cost average" his or her annuity income purchases, in order to take advantage of changes in the annuity market or maximize his or her annuity purchasing power.[4]

Forcing all annuitizations to be full annuitizations would thwart these types of legitimate planning goals. More generally, individuals may be reluctant to annuitize the full amount of their deferred annuity savings to provide retirement income, due to uncertainty about future financial needs and concerns over the loss of liquidity that sometimes accompanies annuitization. As a result, the inability to partially annuitize has been viewed as a potential disincentive to annuitization in general. The new law is designed to remove that disincentive and thereby better promote the societal benefits of annuitization.

TECHNICAL OBSTACLES

Before Congress enacted the new law, officials within the IRS and Treasury Department had voiced technical concerns with achieving exclusion ratio treatment for partial annuitizations under existing IRS regulations. Of course, to qualify for exclusion ratio treatment, an annuity distribution must be an "amount received as an annuity" within the meaning of section 72(b).[5] Otherwise, distributions from non-qualified annuities are taxed using the income-first ordering rule of section 72(e). The technical problem with partial annuitizations stemmed from how the regulations define "amounts received as an annuity."

In particular, the regulations provide that only certain types of payments made on or after the "annuity starting date" can qualify as amounts received as an annuity.[6] The annuity starting date is generally the date on which the obligations under "the contract" become fixed.[7] The most significant technical question that arose was whether the obligations under "the contract" have become fixed when a partial annuitization occurs, given that the owner can still take various actions with respect to the contract's remaining, non-annuitized portion. In essence, the question was whether a contract can have more than one annuity starting date, or whether the regulations require each contract to have only one annuity starting date.

Advocates of partial annuitization argued that the regulations could be read as allowing multiple annuity starting dates with respect to amounts held under one annuity contract, and pointed out that no published guidance has ever reached a contrary conclusion.[8] Still, the government's technical concerns persisted, and the IRS ultimately placed partial annuitization on the "no rule" list as an area under study, where it has remained for the last three years.[9]

THE TREASURY DEPARTMENT'S PROPOSAL

In early 2010, the Treasury Department set out to eliminate the uncertainty surrounding partial annuitizations by proposing a legislative fix. In particular, the Administration's budget for the 2011 fiscal year included a proposal to amend section 72 in a manner that would facilitate partial annuitizations for non-qualified annuities. The Treasury Department explained that the proposal was needed because "the possibility that a partial annuitization could be taxed on an income-first basis rather than on a proportionate basis discourages some taxpayers from annuitizing existing deferred annuity contracts at a time when annuity payments are needed to fund their retirement."[10]

The Treasury Department also explained that its proposal was aimed at promoting consistency between partial annuitizations and partial exchanges. In that regard, as a mechanical matter, a partial annuitization can be accomplished in two different ways. First, a portion of a deferred annuity's cash value can be applied to an annuity option under that contract—a so-called "direct" partial annuitization. Alternatively, a portion of the cash value can be exchanged tax-free for a second deferred annuity, and then one of those contracts can be annuitized—a so-called "indirect" partial annuitization. The Treasury Department noted that current law does not address direct partial annuitizations, whereas it does allow indirect partial annuitizations in certain circumstances.[11]

As a result, the Treasury Department proposed in February 2010 that legislation be enacted to expressly allow direct partial annuitizations. The proposed legislation was similar to a provision in a bill that former Rep. Earl Pomeroy (D-ND) introduced in the 111th Congress. Mr. Pomeroy's bill, which included two additional provisions that also were aimed at encouraging annuitization, would have provided an exclusion ratio for any partial annuitization, regardless of the payment term.[12] The Treasury proposal, on the other hand, limited exclusion ratio treatment to certain forms of payout. The legislation that Congress ultimately enacted followed the Treasury approach. The specifics of the final legislation are discussed next.

THE NEW LEGISLATION

The new legislation amends section 72 to provide exclusion ratio treatment for certain amounts received pursuant to a partial annuitization of a non-qualified deferred annuity. To be eligible for the exclusion ratio, the amounts must be received as an annuity for a period of 10 years or more, or for the lives of one or more individuals.

If the payment stream satisfies this requirement, the annuitized and non-annuitized portions of the contract are treated as separate contracts for purposes of section 72. The new law also clarifies that the after-tax "investment in the contract" is allocated on a *pro rata* basis between the annuitized and non-annuitized portions of the contract. This *pro rata* allocation applies for purposes of the rules of section 72 governing the exclusion ratio, investment in the contract, expected return, annuity starting date, and amounts not received as an annuity. The new law also expressly provides that a separate annuity starting date is determined with respect to the annuitized and non-annuitized portions of the contract. These clarifications effectively eliminate the technical obstacles to partial annuitization that had been raised in the past.

Indeed, the Treasury Department described a desire to treat direct and indirect partial annuitizations consistently as a rationale for proposing the new legislation in the first instance.

The provision will become effective with respect to amounts received in taxable years beginning after Dec. 31, 2010. The provision does not, however, change the current law rules governing distributions from qualified retirement plans (such as 401(k) plans) or IRAs. Such distributions are governed by different rules than non-qualified annuities, and those rules already allow for a *pro rata* recovery of any basis (*e.g.*, after-tax contributions) irrespective of the form of distribution from the annuity.

COMPARISON TO PARTIAL EXCHANGES

As explained above, the new legislation addresses only "direct" partial annuitizations that occur within a deferred annuity contract; it does not address "indirect" partial annuitizations that occur in two steps using a partial exchange followed by an annuitization. Although not covered by the legislation, the latter type of transaction has been the subject of recent IRS guidance.

Rev. Proc. 2008-24 permits the tax-free exchange of a portion of a deferred annuity contract under section 1035 if certain conditions are met. The IRS placed restrictions on

CONTINUED ON **PAGE 8**

the tax-free exchange treatment in light of concerns that taxpayers might use partial exchanges to avoid the income-first ordering rule of section 72(e).[13] As a result, the guidance provides that tax-free treatment applies to a partial exchange only if 1) no withdrawal or surrender with regard to either contract is made within 12 months of the partial exchange, or 2) an enumerated exception in section 72(q)(2), or any similar life event, occurred between the exchange and the withdrawal or surrender.

Section 72(q)(2) generally lists exceptions to the 10 percent penalty tax that section 72(q)(1) otherwise imposes on certain premature distributions from non-qualified annuity contracts. Rev. Proc. 2008-24 borrows some, but not all, of those exceptions and incorporates them as exceptions to the 12-month waiting period that the revenue procedure imposes on withdrawals and surrenders following a partial exchange. Noticeably absent from the list of section 72(q)(2) exceptions that Rev. Proc. 2008-24 incorporates are the exception for substantially equal periodic payments (SEPPs) for life or life expectancy and the exception for payments under an immediate annuity.[14] The revenue procedure suggests that such payments were excluded from the list of exceptions to the 12-month waiting period because partial annuitization is on the IRS "no rule" list. In other words, the IRS apparently viewed SEPP and immediate annuity distributions following a partial exchange as a mechanism to accomplish a two-step partial annuitization, which the IRS was not willing to sanction at the time.

Now that Congress itself has blessed *direct* partial annuitizations, however, it would seem appropriate for the IRS and Treasury Department to facilitate *indirect* partial annuitizations that are accomplished through a partial exchange. Indeed, the Treasury Department described a desire to treat direct and indirect partial annuitizations consistently as a rationale for proposing the new legislation in the first instance. It is widely understood that the IRS and Treasury Department are actively working on updating the partial exchange guidance, although it is unclear whether any attempt will be made to harmonize the treatment of direct and indirect partial annuitizations.[15]

If the government undertakes such a harmonization effort, another aspect that might be considered relates to the limitations that Congress placed on direct partial annuitizations. As summarized above, only those direct partial annuitizations that are for life or at least 10 years will receive exclusion ratio treatment under the legislation. This payment term requirement presumably reflects a concern by the government that a partial annuitization could be used to avoid the income-first ordering rule of section 72(e)—the same basic concern at which the partial exchange guidance of Rev. Proc. 2008-24 is directed.

In that regard, section 72(e) was enacted to discourage the use of annuities as short-term investments and to encourage their use for long-term retirement security.[16] By limiting exclusion ratio treatment for direct partial annuitizations to those that provide payments for life or 10 years, the Treasury Department (in the 2010 Green Book) and Congress (in the new law) apparently were comfortable that the intent of section 72(e) would be preserved. It will be interesting to see if the Treasury Department and the IRS adopt a similar view with respect to two-step, indirect partial annuitizations that occur through partial exchanges, or whether some differences between direct and indirect partial annuitizations will persist.

For consumers, any such differences between the treatment of direct and indirect partial annuitizations could have unfortunate consequences. In that regard, there are non-tax reasons why one might prefer an indirect partial annuitization to a direct one, and *vice versa*. For example, a contract that is newly issued in a partial exchange may offer investment guarantees and features that are not available under the existing contract. Likewise, an existing contract may guarantee payments based on a higher interest rate and a more favorable mortality table than would be available under a contract newly issued following a partial exchange. It would be somewhat unfortunate if such non-tax factors were given a backseat to tax concerns based on any lingering differences between the treatment of direct and indirect partial annuitizations.

CONCLUSION

In sum, the new legislation provides a clarification on the tax treatment of direct partial annuitizations that the life insurance industry has been seeking for over a decade. It is certainly a welcomed development, and should make a significant contribution to the government's and the life insurance industry's common goal of providing greater retirement income security to retired Americans.

END NOTES

* The author thanks Joe McKeever and Mark Griffin, both with Davis & Harman LLP, for their helpful comments and suggestions on this article.

1 Pub. L. No. 111-240 § 2113 (2010).

2 *See, e.g.*, Department of Labor and Department of the Treasury, Request for Information on Lifetime Income Options for Participants and Beneficiaries in Retirement Plans, 75 Fed. Reg. 5253 (Feb. 2, 2010) (requesting public comment on how to better facilitate and promote annuitization in qualified retirement plans).

3 *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, at 74 (Feb. 2010) (hereinafter, the "2010 Green Book").

4 The purchasing power of annuity premiums can fluctuate with interest rates, but generally increases with age. As a result, many financial advisors counsel individuals to gradually annuitize their assets. *See, e.g.*, Jonathan Clements, *Retirement on the Installment Plan: A Less-Risky Way to Buy Annuities*, Wall Street Journal, Nov. 23, 2005.

5 Unless otherwise indicated, references to sections mean sections of the Internal Revenue Code of 1986, as amended.

6 The regulations impose two additional definitional requirements regarding amounts received as an annuity. Such amounts must be payable in periodic installments at regular intervals over a period of more than one full year, and the total of the amounts payable must be determinable at the annuity starting date (or must be payable for a definite or determinable time, in the case of a variable contract). Treas. Reg. section 1.72-2(b).

7 Section 72(c)(4) provides, in relevant part, that for purposes of section 72 "the annuity starting date in the case of any contract is the first day of the first period for which an amount is received as an annuity under the contract." Similarly, and subject to certain exceptions not relevant here, Treas. Reg. section 1.72-4(b)(1) defines annuity starting date as the later of "(i) The date upon which the obligations under the contract became fixed, or (ii) The first day of the period … which ends on the date of the first annuity payment."

8 Although there has been no published guidance on the issue, one private letter ruling that the IRS has since revoked suggested that the regulations under section 72 preclude partial annuitizations. *See* PLR 8720011 (Feb. 9, 1987) (considering the tax treatment of a deferred annuity and an immediate annuity purchased simultaneously, and stating that if the contracts are considered a single, integrated contract, "the amounts received with respect to the Immediate Annuity would be considered cash withdrawals prior to the annuity starting date. See section 1.72-4(b)(1) of the Income Tax Regulations, which defines the annuity starting date in terms that preclude a partial annuitization of the contract.") The IRS revoked this private letter ruling in PLR 9015010 (Jan. 8, 1990).

9 *See* section 5.02 of Rev. Proc. 2010-3, 2010-1 I.R.B. 110; Rev. Proc. 2009-3, 2009-1 I.R.B. 107; and Rev. Proc. 2008-3, 2008-1 I.R.B. 110.

10 2010 Green Book, *supra* note 3, at 74.

11 *See* Rev. Proc. 2008-24, 2008-13 I.R.B. 684. The relationship between the partial exchange guidance and the partial annuitization legislation is discussed further below.

12 *See* H.R. 2748, 111th Cong. § 4 (2009). In addition to providing exclusion ratio treatment for partial annuitizations, the bill would encourage annuitization by 1) excluding from income a portion of lifetime income payments received from IRAs, qualified retirement plans (other than defined benefit plans), and non-qualified annuities, and 2) excluding the value of longevity insurance from amounts subject to required minimum distributions under section 401(a)(9). The bill also includes a provision stating that the prospective enactment of the partial annuitization rule creates no inference as to the treatment of partial annuitizations in prior years. The same partial annuitization provisions were included in a bill that Mr. Pomeroy introduced in the 110th Congress. *See* H.R. 4150, 110th Cong. § 4 (2007).

13 For example, assume that a deferred annuity has a cash value of $100, comprised of a $50 investment in the contract and $50 of gain. If the owner wished to withdraw $50, he could request a partial withdrawal in that amount and pay tax on the full $50 under the income-first rule of section 72(e). Alternatively, the individual could exchange the contract for two contracts, each with a $50 cash value, $25 investment in the contract, and $25 built-in gain. He then could surrender one of those contracts for $50, recover $25 of his investment in the contract, and pay tax only on the $25 gain in the surrendered contract.

14 The SEPP and immediate annuity rules are in section 72(q)(2)(D) and section 72(q)(2)(I), respectively.

15 The "Priority Guidance Plan" for 2010-2011 that the IRS and Treasury Department jointly released on Dec. 7, 2010, indicated that published guidance is forthcoming on "the tax treatment of a partial exchange of an annuity contract." A similar item, but which also included guidance on partial annuitizations, has been on the Priority Guidance Plan since 2008-2009.

16 Staff of the J. Comm. on Tax'n, 97th Cong., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 361 (Comm. Print 1982).

Bryan W. Keene is a partner in the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *bwkeene@davis-harman.com.*

LIFE BEYOND 100: REV. PROC. 2010-28 FINALIZES THE "AGE 100 METHODOLOGIES" SAFE HARBOR

By John T. Adney, Craig R. Springfield, Brian G. King and Alison R. Peak

In 2009 the Internal Revenue Service ("Service") issued Notice 2009-47,[1] which proposed a safe harbor for calculations under sections 7702 and 7702A[2] in the case of life insurance contracts that mature after the insured attains age 100. After receiving comments from the life insurance industry, including the American Council of Life Insurers ("ACLI"), the Service released Revenue Procedure 2010-28,[3] which sets forth the final safe harbor, in August 2010. The new guidance largely adheres to the recommendations made by the 2001 CSO Maturity Age Task Force formed by the Taxation Section of the Society of Actuaries in 2005 ("SOA Task Force"). The Task Force's recommendations were published in *Taxing Times* in May 2006.

To satisfy the cash value corridor, the death benefit under the contract at any time cannot be less than the applicable percentage of the cash surrender value as determined under the table set forth in section 7702(d)(2).

Rev. Proc. 2010-28 has been welcomed by many in the industry as a helpful clarification of the application of sections 7702 and 7702A to life insurance contracts that are based on the 2001 CSO mortality tables ("2001 CSO Tables"). Under the safe harbor, the Service will not challenge the qualification of a contract as a life insurance contract under section 7702, or assert that a contract is a modified endowment contract ("MEC") under section 7702A, if the contract satisfies the requirements of those provisions using the "Age 100 Safe Harbor Testing Methodologies" prescribed in section 3.02 of Rev. Proc. 2010-28.

In this article, which follows our September 2009 *Taxing Times* article,[4] we first briefly review the relevant Code provisions and the background to the issuance of Rev. Proc. 2010-28. We then delve into the revenue procedure's Age 100 Safe Harbor Methodologies and some considerations that insurers should keep in mind in applying these Methodologies. Finally, we conclude with a discussion of several points not addressed in the revenue procedure. For additional background on this subject, we refer you to our September 2009 *Taxing Times* article, "IRS Issues Proposed Safe Harbor Prescribing 'Age 100 Methodologies.'"

RELEVANT PROVISIONS OF THE CODE

Section 7702. Section 7702 contains the definition of a "life insurance contract" for all purposes of the Code, generally applying to life insurance contracts issued after Dec. 31, 1984.[5] To qualify as a life insurance contract, a contract must be a life insurance contract under applicable law and must satisfy either the cash value accumulation test (the "CVA Test") of section 7702(a)(1) and (b) or the guideline premium limitation and cash value corridor test (the "GP Test") of section 7702(a)(2), (c) and (d).

As provided in section 7702(b)(1), a contract will satisfy the CVA Test if, by the terms of the contract, its cash surrender value, as defined by section 7702(f)(2), may not at any time exceed the net single premium required at such time to fund the future benefits under the contract. Determinations under the CVA Test are based upon the computational rules of section 7702(e). Under the alternative testing method, a contract will satisfy the GP Test if the contract satisfies both the requirements in section 7702(c), regarding the guideline premium limitation, and the requirements in section 7702(d), imposing the cash value corridor test. To meet the guideline premium limitation, the sum of the premiums paid under the contract cannot at any time exceed the guideline premium limitation,[6] which as of any date is the greater of the guideline single premium or the sum of the guideline level premiums to that date.[7] Subject to a number of computational rules and constraints, the guideline single premium is the premium at issue that would be required to fund the future benefits under the contract.[8] Similarly, the guideline level premium is the level annual amount, payable over a period not ending before the insured attains age 95, computed on the same basis as the guideline single premium, except that the interest rate assumption used is 4 percent instead of 6 percent.[9] To satisfy the cash value corridor, the death benefit under the contract at any time cannot be less than the applicable percentage of the cash surrender value as determined under the table set forth in section 7702(d)(2).

Governing the application of both the CVA Test and the GP Test are certain computational rules found in section 7702(e). Of central importance to the new guidance, the computational rule in section 7702(e)(1)(B) provides that for purposes of both tests, "the maturity date [of a contract] … shall be deemed to be no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100." Prior to the issuance of Rev. Proc. 2010-28, only limited guidance had addressed the statute's deemed maturity date of a life insurance contract: a private letter ruling on the subject was issued by the Service during 2008,[10] and more broadly, Treas. Reg. § 1.7702-2 provided guidance on the attained age of the insured for purposes of applying the endowment or maturity date rules of section 7702(e).

Modified Endowment Contracts. Section 7702A provides that a life insurance contract is a modified endowment contract ("MEC") if the contract is entered into on or after June 21, 1988, and either fails to meet the 7-pay test or is received in exchange for a MEC. A contract that satisfies the 7-pay test will maintain the traditional treatment of withdrawals and loans that has applied to life insurance contracts. Under a MEC, however, distributions (including loans) are treated as distributions of income before any investment in the contract is recovered, and a penalty tax also may apply. A life insurance contract fails to meet the 7-pay test (and thus constitutes a MEC) if the accumulated amount paid under the contract at any time during the first 7 contract years exceeds the sum of the net level premiums that would have to be paid on or before such time if the contract were to provide for paid-up future benefits (including death benefits) after the payment of 7 level annual premiums. Under section 7702A(c)(1)(B), the determination of the 7 level annual premiums generally is made by applying the computational rules of section 7702(e), including the rule deeming the maturity date to be no earlier than the day on which the insured attains age 95 and no later than the day on which the insured attains age 100.

Mortality Tables. Guideline premiums and net single premiums are determined on the basis of reasonable mortality charges that do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is issued.[11] The same reasonable mortality charge standard applies for purposes of applying the 7-pay test under section 7702A(c)(1)(B). Section 807(d)(5)(A), in turn, provides that the term "prevailing commissioners' standard tables" means, with respect to any contract, the most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners that are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 states when the contract was issued, subject to a 3-year transition period allowed by section 807(d)(5)(B). The 2001 CSO Tables became the prevailing tables within the meaning of section 807(d)(5) during 2004 and are mandatory in all 50 states and the District of Columbia for contracts issued after Dec. 31, 2008.

HISTORY BEHIND THE GUIDANCE

The 2001 CSO Tables extend to age 121, whereas the prior CSO tables—the 1958 and 1980 CSO Tables—ended at age 100. Due to this change, life insurance companies now typically issue life insurance contracts with maturity dates at age 121 (and, as was the case even under prior mortality tables, some contracts do not specify any maturity date). With these changes in contract design, questions began to arise with respect to how such contracts should be administered under sections 7702 and 7702A. Specifically, in calculating guideline premiums and net single premiums, some wondered whether it was permissible to use a contract's actual maturity date, even though such date exceeded the maximum deemed maturity date (age 100) specified in section 7702. Others were concerned with how the tests should be applied technically, even if it was assumed that the maximum age of 100 controlled. Still others were concerned about the seemingly inconsistent requirements of the statute's maximum deemed maturity date and the requirement of calculating a "7-pay" premium under section 7702A in circumstances where a contract was issued or materially changed within less than 7 years of the maximum deemed maturity date.

In 2005, the SOA Task Force was formed to study the interaction of the 2001 CSO Tables and the tax law, including the application of section 7702's requirement of a deemed maturity date between the insured's age 95 and 100 to a contract that may provide coverage through the end of the 2001 CSO Table at the insured's age 121. The SOA Task Force proposed methodologies, published in the May 2006 issue of *Taxing Times*, that would be actuarially acceptable under sections 7702 and 7702A for calculations under contracts that do not provide for actual maturity by or before age 100. The ACLI and others in the life insurance industry also had conversations with the Service and Treasury Department requesting that guidance be issued on this subject.[12]

CONTINUED ON **PAGE 12**

The Service and Treasury Department responded by issuing Notice 2009-47 (the "Notice"), which set forth a proposed safe harbor and requested comments on certain issues that could arise in situations where a life insurance contract matures after the insured has attained age 100. While the proposed safe harbor generally followed the recommendations of the SOA Task Force, it included a condition limiting its application to cases where the contract provided at all times a death benefit equal to or greater than 105 percent of the contract's cash value. Few if any existing contracts or approved forms met such a condition, of course, and the ACLI and others submitted comments in response to the Notice[13] objecting to the 105 percent corridor, suggesting technical changes to the Notice's other safe harbor rules, and responding to questions on constructive receipt and like issues raised in the Notice.[14]

Following up on the Notice, the Service released Rev. Proc. 2010-28 in August 2010, in most key respects adopting the methodologies that were set forth in the Notice. In doing so, the revenue procedure specifically references the role of the SOA Task Force and the publication of its recommendations in *Taxing Times*. Rev. Proc. 2010-28 also rectifies certain minor problems that were present in the Notice's safe harbor rules and, significantly, eliminates the onerous 105 percent corridor condition. Apart from eliminating that condition, the revenue procedure maintains silence on the considerations that appear to have led the Service to incorporate the condition in the Notice, including on the questions the Service raised in the Notice. Instead, Rev. Proc. 2010-28 applies—and provides a safe harbor—only with respect to the application of sections 7702 and 7702A. Limiting the guidance only to the application of sections 7702 and 7702A is consistent

with comments the Service received, *i.e.*, to the effect that the safe harbor should address only the application of these Code provisions and should not try to address the extraneous issues such as the application of the constructive receipt doctrine after an insured's age 100.

AGE 100 SAFE HARBOR METHODOLOGIES

The safe harbor in Rev. Proc. 2010-28 provides that the Service will not challenge the qualification of a contract as a life insurance contract under section 7702, or assert that a contract is a MEC under section 7702A, if the contract satisfies the requirements of those provisions using all of the "Age 100 Safe Harbor Testing Methodologies." (See sidebar, page 15). According to the "Purpose" statement at the outset of the revenue procedure, the safe harbor concerns the application of sections 7702 and 7702A to life insurance contracts that 1) have mortality guarantees based on the 2001 CSO Tables, and 2) may continue in force after the day on which the insured attains age 100.[15] It is clear that the guidance applies to contracts that are subject to 2001 CSO Tables; it is less clear whether contracts subject to 1980 CSO Tables can also fall within this safe harbor. While Rev. Proc. 2010-28 appears to apply technically only to a contract based on the 2001 CSO mortality tables (since the "Purpose" section of the revenue procedure states that it provides a safe harbor for contracts with mortality guarantees based on the 2001 CSO Tables), it would be a sound practice to use the Age 100 Safe Harbor Methodologies for a contract subject to the 1980 CSO Tables. Thus, for example, even though the 1980 CSO Tables terminate at an insured's age 100, those Methodologies could be employed in the case of universal life insurance contracts with maturity dates beyond age 100 or whole life insurance contracts that do not specify any maturity date.

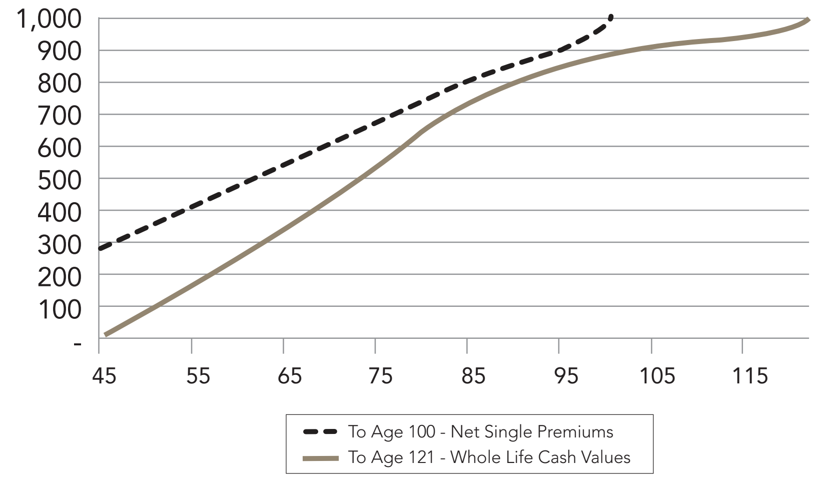
Calculations. Rev. Proc. 2010-28 makes it clear that in order to take advantage of the safe harbor, for all calculations under sections 7702 and 7702A (other than the cash value corridor), the contract must be deemed to mature on age 100, notwithstanding a later contractual maturity date.[16] The rest of the safe harbor methodologies are keyed to this assumption. In that regard, the date the insured attains age 100 must be used as the endowment date for calculating net single premiums and necessary premiums.[17] Furthermore, to determine the guideline level premium, premium payments must be assumed to be made through the day the insured attains age 99.[18] Also, for purposes of the 7-pay test, in the case of a contract issued or materially changed within fewer than 7 years of the day the insured attains age 100 (which likely would be very unusual for most contracts), the net level premium must be computed assuming level annual premium payments over the number of years between the date the contract is issued or materially changed and the date the insured attains age 100.[19]

To illustrate the effect of these rules, consider the example of an ordinary whole life insurance contract with cash values based on the 2001 CSO Tables and 4 percent interest. The first graph to the right compares the development of the guaranteed tabular cash values of such a contract (which reflect the termination of the 2001 CSO Tables at age 121) with the net single premiums under section 7702(b) (which reflect the deemed maximum maturity date of age 100).

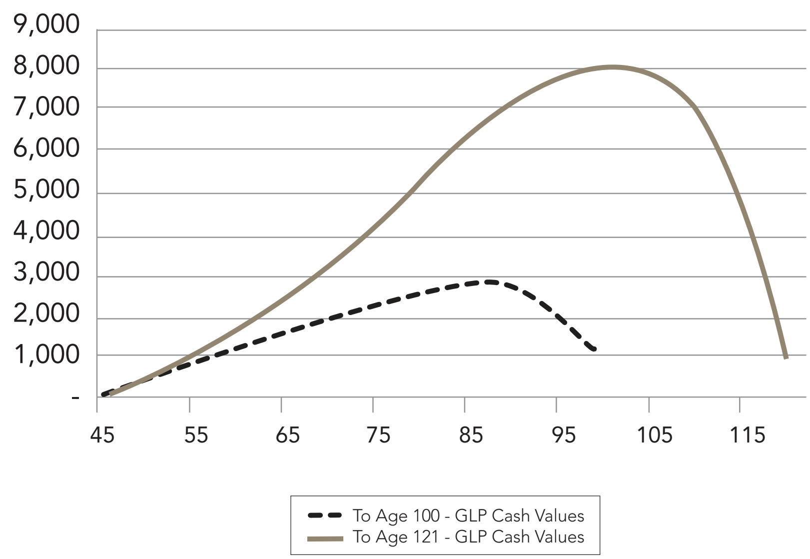
As another illustration, consider the example of a universal life insurance contract with mortality guarantees based on the 2001 CSO Tables and 4 percent interest that is funded with level annual premiums and provides an increasing death benefit (equal to face plus cash value). The second graph to the right first shows the development of cash values based on level annual premiums (determined without regard to the guideline premium limitation) that are sufficient in amount to allow adequate funding to age 121, so that an endowment benefit equal to the face amount may be paid on that date. The graph then, however, shows the development of guaranteed cash values based on payment of guideline level premiums, which are lower than those that allow for full funding due to the requirement to reflect a maximum deemed maturity date of age 100. Thus, in this second illustration, the requirement to use a maturity date not exceeding age 100 in the calculation of the guideline level premium reduces the otherwise applicable limitation.

Time Periods. In addition to the calculations for section 7702 and 7702A, the safe harbor also provides guidance with respect to the various testing periods. More specifically, the safe harbor provides that guideline level premiums accumulate through a date no earlier than the day the insured attains age 95 and no later than the day the insured attains age 99.[20] Thereafter, premium payments are allowed and are tested against the guideline premium limitation, but the sum of the guideline level premiums does not change after the day the insured attains age 100.[21] Also, in the case of a contract issued or materially changed within fewer than 7 years of the day the insured attains age 100, the sum of the net level premiums increases until the day the insured attains age 100.[22] Thereafter, the sum of the net level premiums does not increase, but premium payments are allowed and are tested against this limit for the remainder of the 7-year period.[23]

CASH VALUE PER $1,000 OF DEATH BENEFIT
Male, Issue Age 45



CASH VALUE PER $1,000 OF DEATH BENEFIT
Male, Issue Age 45



CONTINUED ON **PAGE 14**

At first glance it appears that there is a discrepancy between the date assumption required for the accrual of guideline level premiums (*i.e.*, through age 99) and the date after which the guideline premium limitation does not change (*i.e.*, after age 100). Although not expressly stated, the difference appears to account for the possibility of an adjustment event in the 99th year. More specifically, it appears that section 3.02(d) of Rev. Proc. 2010-28 contemplates that the last guideline level premium would accrue on the date the insured attains age 99, and the sum of guideline level premiums would not thereafter be altered except in the case of an adjustment event during the contract year when the insured has an attained age of 99. Little guidance exists regarding how mid-year adjustment events should be handled in the context of the guideline level premium, and practices among insurers may vary while still being actuarially sound as well as consistent with the statutory requirements. It is perhaps appropriate that the Service did not address what specifically needs to be done to the sum of guideline level premiums upon a change during the 99th year, while at the same time recognizing that some change may be needed due to an adjustment event prior to the date when the insured reaches attained age 100.

Little guidance exists regarding how mid-year adjustment events should be handled. …

A similar issue exists for the calculation of 7-pay premiums under section 3.02(e) and (f) of Rev. Proc. 2010-28. These provisions similarly appear to contemplate that net level premiums generally would accrue until the insured's attained age of 99, but thereafter 7-pay premiums may need to be recalculated if there is a material change in the 99th year. While section 3.02(f) of Rev. Proc. 2010-28 could be read as contemplating accrual of the final net level premium on the date the insured reaches attained age 100, assuming a final payment at age 99 appears to be intended. This is because "net level premiums" are assumed paid at the beginning of each year of the applicable period, the end of the applicable period is the insured's age 100, per section 3.02(a) of Rev. Proc. 2010-28, and section 3.02(e) of Rev. Proc. 2010-28 specifies that net level premiums are calculated "over the number of years between the date on which the contract is issued or materially changed and the date on which the insured attains age 100."

To illustrate these rules, consider the case of a life insurance contract covering a male insured with a $100,000 level death benefit, guaranteed cash values based on the 2001 CSO Tables and 4 percent interest, and a current cash value of $ 47,200 on the date of a material change under section 7702A(c)(3)(A)(i), when the insured is age 96. In this circumstance, a 4-pay premium effectively is calculated (tentatively equal to $35,362) before application of the so-called "rollover rule" of section 7702A(c)(3)(A)(ii). Also, under the rollover rule, this tentative 4-pay premium is reduced by the product of (1) the cash surrender value as of the date of the material change ($47,200) (which we have assumed is not in part due to payment of unnecessary premiums), and (2) a fraction the numerator of which equals the 4-pay premium for the future benefits under the contract and the denominator of which equals the net single premium for such benefits computed using the same assumptions used in determining the 4-pay premium (.38717), with the resulting 4-pay premium being $17,087.

Changes to Contracts. If a contract is issued or materially changed within fewer than 7 years from the time the insured attains age 100 (so that, for example, a 4-pay premium is calculated, as discussed above), and the contract thereafter has a reduction in benefits, the reduction in benefits rule under section 7702A(c)(2) will apply for 7 years from the date of issue or the date of the material change (*i.e.*, in the example, it would apply for 3 years beyond the period during which 7-pay premiums accrue).[24] Also, in the case of a joint and survivor life insurance contract, the reduction in benefits rule would apply for the life of the contract pursuant to section 7702A(c)(6), including after one or both of the insureds attains age 100.[25] By so applying these reduction in benefits rules under the safe harbor, the Service appears to have intended to preserve the anti-abuse nature of the rules. Also, application of these rules beyond age 100 can relate back to calculations prior to age 100, which arguably is not inconsistent with the maximum deemed maturity date requirement.

In contrast, a change in benefits under (or in other terms of) a life insurance contract that occurs on or after the insured attains age 100 is not treated as a material change for purposes of section 7702A(c)(3) or as an adjustment event for purposes of section 7702(f)(7).[26] Thus, necessary premium testing under section 7702A(c)(3)(B)(i) ceases on the day the insured attains age 100.[27] Because the adjustment rule no longer applies after this date, the recapture rules of section 7702(f)(7)(B) – (E) also cannot apply, since one of the prerequisites to application of these rules is that there must be "a change described in [section 7702(f)(7)(A), *i.e.*, the adjustment rule, that] reduces benefits under the contract."

NO INFERENCE AND OTHER ISSUES

A much appreciated, and appropriate, clarification is the inclusion of "no inference" language in section 3.03 of Rev. Proc. 2010-28. Specifically, in keeping with a request made in the ACLI's letter commenting on Notice 2009-47, the section states that "[n]o adverse inference should be drawn with respect to the qualification of a contract as a life insurance contract under § 7702, or its status as not a MEC under § 7702A, merely by reason of a failure to satisfy all of the requirements of this section [of Rev. Proc. 2010-28]." This "no inference" provision reinforces the fact that the Age 100 Safe Harbor Methodologies are just that, a safe harbor, and not black letter law for purposes of applying sections 7702 and 7702A to contracts that have maturity dates after the insured's age 100.

A further "no inference" provision states that "[f]urthermore, this revenue procedure neither answers nor comments on any issue raised in Notice 2009-47 that is not specifically covered by the safe harbor in this revenue procedure."[28] As mentioned above, the revenue procedure did not include the requirement that the contract provide a death benefit at all times equal to 105 percent of the cash value. Thus, Rev. Proc. 2010-28 does not address the issues that gave rise to this requirement, *e.g.*, regarding application of the constructive receipt doctrine. Based on this further "no inference" provision, it appears that the Service revised the scope of the guidance so as to focus only on the technical requirements of sections 7702 and 7702A, which is consistent with the scope of the SOA Task Force recommendations. In limiting the scope of the guidance and by including this further "no inference" provision, the Service has clarified that Rev. Proc. 2010-28 should not be construed, one way or the other, as adopting a position with respect to those issues associated with the 105 percent corridor.

CONCLUDING THOUGHTS

Sections 7702 and 7702A are highly technical, involving a combination of legal and actuarial requirements, and developments such as the promulgation of the 2001 CSO Tables certainly have the potential to exacerbate uncertainty. The Service is to be commended for its efforts with respect to Rev. Proc. 2010-28, in the process used to develop the guidance (working with the industry and taking into consideration the SOA Task Force's recommendations), in offering the final guidance in the form of a safe harbor, and in emphasizing the "safe harbor" nature of the guidance, since the requirements of the statutes may be interpreted in other reasonable and actuarially appropriate manners.

A Shorthand Guide to the New Age 100 Safe Harbor Methodologies

(a) All section 7702 and 7702A calculations assume age 100 maturity.

(b) NSP (CVAT) and "necessary premium" calculations assume endowment at age 100.

(c) GLP is calculated assuming premiums through age 99.

(d) GLPs accrue through date between ages 95 and 99, after which limit applies indefinitely.

(e) 7-pay premiums are computed using remaining durations to age 100.

(f) If 7-pay premiums accrue over fewer than 7 years under (e), accrual ends at age 100, after which limit applies for the remainder of the 7-pay period.

(g) Reduction-in-benefit rules apply regardless of attaining age 100.

(h) Benefit change after age 100 is not material change or adjustment event.

John T. Adney is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *jtadney@davis-harman.com.*

Craig R. Springfield is a partner in the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *crspringfield@davis-harman.com.*

Brian G. King, FSA, MAAA, is a managing director, Insurance Actuarial Services with LECG and may be reached at *bking@lecg.com.*

Alison R. Peak is an associate with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *arpeak@davis-harman.com.*

CONTINUED ON **PAGE 16**

END NOTES

[1] 2009-24 I.R.B. 1083.
[2] Unless otherwise indicated, all references to "section" are to provisions of the Internal Revenue Code of 1986, as amended (the "Code").
[3] 2010-34 I.R.B. 270.
[4] John T. Adney, Craig R. Springfield, Brian G. King and Alison R. Peak, "IRS Issues Proposed Safe Harbor Prescribing 'Age 100 Methodologies,'" *Taxing Times*, vol. 5, no. 3, at p. 19 (Sept. 2009).
[5] Deficit Reduction Act of 1984, Pub. L. No. 98-369 (1984).
[6] Section 7702(c)(1).
[7] Section 7702(c)(2).
[8] Section 7702(c)(3).
[9] Section 7702(c)(4).
[10] PLR 200910001 (Sept. 8, 2008) (holding that the net single premium for individual certificates provided under a group permanent variable life insurance contract will be determined by assuming that the face amount of each contract is provided until age 100 of the insured). Private letter rulings cannot be cited as precedent, and only the taxpayer that receives the ruling may rely on it. *See* section 6110(k)(3).
[11] *See* sections 7702(b)(2)(B), 7702(c)(3)(B)(i) and 7702(c)(4).
[12] Letter from Laurie Lewis, Senior Vice President, Taxes & Ret. Sec., ACLI, to the IRS (Jan. 10, 2005) (submitting comments on Notice 2004-61, 2004-2 C.B. 96 and requesting guidance on the application of section 7702(e)(1)(B)).
[13] Letter from Walter Welsh, Executive Vice President, Taxes & Ret. Sec., ACLI, to the IRS (Oct. 6, 2009) (submitting comments under Notice 2009-47).
[14] These responses are discussed in our article cited in note 4, *supra*.
[15] Rev. Proc. 2010-28, § 1.
[16] *Id.*, at § 3.02(a).
[17] *Id.*, at § 3.02(b).
[18] *Id.*, at § 3.02(c).
[19] *Id.*, at § 3.02(e).
[20] *Id.*, at § 3.02(d).
[21] *Id.*
[22] *Id.*, at § 3.02(f).
[23] *Id.*
[24] *Id.*, at § 3.02(g).
[25] *Id.*
[26] *Id.*, at § 3.02(h).
[27] *Id.*
[28] *Id.*, at § 3.03.

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

CONTINUED ON PAGE 18

IRS PROPOSES … | FROM PAGE 17

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 determine 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.

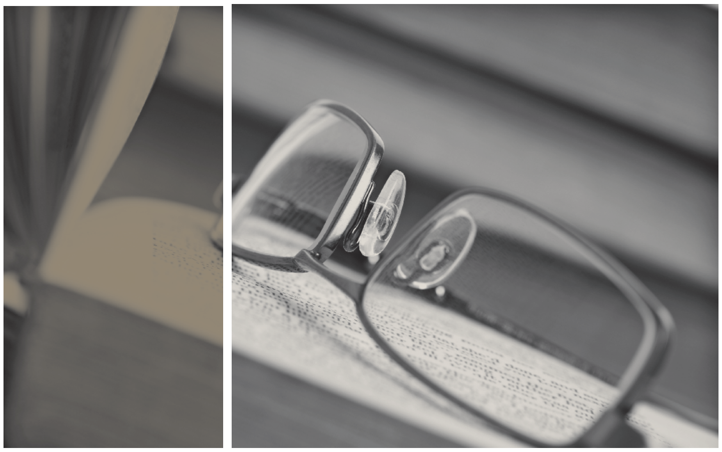
7 *See Erie Lighting Co. v. Commissioner*, 93 F.2d, 883 (1st Circ. 1937), rev'g 35 B.T.A. 906 (1937); *Anderson-Clayton Securities Corporation*, 35 B.T.A. 795 (1937) and Rev. Rul. 69-126, 1969.1 C.B. 218.

8 Prop. Treas. Reg. § 301.7701-1(f)(3)(ii).

9 Treas. Reg. § 301.7701-3(g).

Lori J. Jones is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *ljones@scribnerhall.com.*

Janel C. Frank is an associate with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *jfrank@scribnerhall.com.*



IRS RELEASES FINAL SCHEDULE FOR REPORTING "UNCERTAIN TAX POSITIONS"

By Craig L. Pichette and Michael E. Bauer

INTRODUCTION

The Internal Revenue Service (IRS) has long sought a means through which to obtain insight into uncertain positions taken by taxpayers not otherwise readily apparent through the information provided with their returns so that it may focus its time and attention upon the proper taxpayers and issues.[1] The IRS's answer: Schedule UTP.

In April 2010 the IRS issued Announcement 2010-30[2] releasing a draft of 2010 Schedule UTP, "Uncertain Tax Position Statement," with instructions, and providing preliminary guidance to taxpayers. Following the release, commentators suggested numerous changes to the scope and content of information to be reported. Responding to these comments, on Sept. 24, 2010 the IRS issued Announcement 2010-75[3] together with final 2010 Schedule UTP and accompanying instructions (the "Instructions").[4]

Final Schedule UTP

Schedule UTP requires certain taxpayers to attach a schedule to their federal income tax return identifying certain "uncertain tax positions," if a) the corporation has taken the position on its U.S. federal income tax return for the year or for a prior tax year and b) either the corporation or a related party recorded a reserve in its audited financial statements for the year with respect to the position, or the entities did not record a reserve because they expected to litigate the position.

Final Schedule UTP contains numerous changes vis-à-vis the previous draft aimed at remedying taxpayer concerns. The primary changes include the following:

- A five-year phase-in of the reporting requirement based upon a corporation's asset size;
- No reporting of a "maximum tax adjustment";
- No reporting of the rationale and nature of uncertainty in the concise description of the position;
- Interaction of Schedule UTP Disclosures and Economic Substance Disclosures; and
- Elimination of Disclosure of Administrative Practice Positions.

FIVE-YEAR PHASE-IN

Pursuant to the Instructions, a corporation must file Schedule UTP with its income tax return if:

- The corporation files Form 1120, 1120-F, 1120-L or 1120-PC;
- The corporation has assets that equal or exceed $100 million (subject to a phase-in, below);
- The corporation or a related party issued audited financial statements reporting all or a portion of the corporation's operations for all or a portion of the corporation's taxable year; and
- The corporation has one or more tax positions that must be reported on Schedule UTP.

The Instructions provide a phase-in for certain corporations determined by their asset size:

- Certain corporations with $100 million or more in assets that have audited financial statements (or are included in the audited financial statements of a related party) will be required to file Schedule UTP beginning with 2010 tax years;
- Corporations with $50 million in assets must file Schedule UTP beginning with 2012 tax years; and
- Corporations with $10 million in assets must file Schedule UTP beginning with 2014 tax years.

The Instructions do not exclude taxpayers participating in the CAP or CIC programs from the Schedule UTP filing requirement.[5] Announcement 2010-75 provides that the IRS will address Schedule UTP compliance in upcoming CAP permanence guidance, which is expected to be released shortly. It also states further that the IRS will consider whether to extend all or a portion of Schedule UTP reporting to other taxpayers (*e.g.*, partnerships and tax-exempt entities) for 2011 or later tax years. These entities are currently not required to file Schedule UTP.

Last, the Instructions provide a transition rule pursuant to which tax positions taken in tax years before 2010 generally need not be reported in 2010 or later. This is the case even if a reserve is recorded in audited financial statements issued in 2010 or later. However, Example 9 in the Instructions appears to provide an exception to this general rule for NOL carryforwards and credit carryforwards. Under the example:

> A corporation incurs a $50 expenditure in 2010 and claims the entire amount as a deduction on its 2010 tax return. The deduction increases the corporation's NOL carryforward from $100 to $150. The corporation uses the entire $150 NOL carryforward on its 2011 tax return. Claiming the $50 deduction in 2010 is a tax position taken in the 2010 tax year because the position would result in an adjustment to a line item on the 2010 tax return if the position is not sustained. The deduction in 2011 of the NOL carried forward from 2010 is a tax position taken on the 2011 tax return, because the position would result in an adjustment to a line item on the 2011 tax return if the position is not sustained. The corporation did not record a reserve with respect to its 2010 tax position, but did record a reserve in its 2011 audited financial statements with respect to its 2011 tax position. Because the corporation did not record a reserve with respect to the tax position taken in 2010, the 2010 tax position is not required to be reported on Schedule UTP. However, because the corporation recorded a reserve for the 2011 tax position in its 2011 audited financial statements, the 2011 tax position must be reported in Part I of Schedule UTP filed with its tax return for the 2011 tax year.

Considering the transition rule above in light of Example 9, it appears that taxpayers would also be required to describe (in their concise description) positions taken in years prior to 2010 to the extent that the taxpayer establishes a reserve in later years with respect to an NOL carryforward (or credit carryforward) due to uncertainty specific to a pre-2010 tax position that is included in the computation of the carryforward. IRS officials have acknowledged this issue and have stated that the IRS intends to issue future guidance that addresses this issue.[6]

ELIMINATION OF MAXIMUM TAX ADJUSTMENT REPORTING

The instructions accompanying draft Schedule UTP required taxpayers to compute a "maximum tax adjustment," which the IRS defined as "the maximum United States federal income tax liability for the tax position if the position were not sustained upon examination by the Service." Responding to concern expressed by numerous commentators regarding this calculation, the IRS eliminated this requirement from final Schedule UTP. Instead, final Schedule UTP generally requires the reporting taxpayer to rank its reportable tax positions, including transfer pricing and other valuation positions, from highest to lowest based on the size of the position's reserve amount computed for audited financial statement purposes. Taxpayers must also designate those tax positions for which the reserve exceeds 10 percent of the aggregate amount of the reserves for all tax positions taken on the return. A box must be checked on the Schedule with respect to these "major tax positions."

Announcement 2010-75 clarifies that "no size needs to be determined with respect to these tax positions and that these positions can be assigned any rank by the corporation."

Also addressed were concerns of commentators regarding the difficulty in computing the maximum tax adjustment for positions which a taxpayer expects to litigate, if challenged by the IRS. Announcement 2010-75 clarifies that "no size needs to be determined with respect to these tax positions and that these positions can be assigned any rank by the corporation." The Instructions clarify that taxpayers are only required to report reserves which are not recorded due to an expectation to litigate. They provide that a corporation must report a tax position for which no reserve was reported if:

> the tax position is one which the corporation or a related party determines the probability of settling with the IRS to be less than 50% and, under applicable accounting standards, no reserve was recorded in the audited financial statements because the corporation intends to litigate the tax position and has determined that it is more likely than not to prevail on the merits in litigation.

Announcement 2010-75 clarifies that taxpayers are not required to report a tax position that a corporation would litigate, if challenged, but that is clear and unambiguous or is immaterial.

ELIMINATION OF CERTAIN REQUIREMENTS IN CONCISE DESCRIPTION

The IRS received a number of comments arguing that the requirement in the instructions to draft Schedule UTP that

CONTINUED ON **PAGE 22**

taxpayers include the rationale and nature of the uncertainty as part of the concise description of the uncertain tax position exceeded disclosure requirements under FIN 48 and conflicted with the IRS's policy of restraint as well as its "stated objective not to require taxpayers to disclose their assessment of the strength or weakness of the position."[7]

The Instructions remove the requirement that taxpayers include within their concise description the rationale and nature of the uncertainty. According to the Instructions, the reporting taxpayer must include a description of the relevant facts affecting the tax treatment of the position and information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the issue. The Instructions state that, in most cases, the description need not exceed a few sentences; however, "Available on Request" is not an adequate description.

INTERACTION OF SCHEDULE UTP DISCLOSURES AND ECONOMIC SUBSTANCE DISCLOSURES

In the Announcement the IRS states that in the case of a transaction that is not a reportable transaction, the IRS will treat a complete and accurate disclosure of a tax position on Schedule UTP as satisfying Internal Revenue Code section 6662(i) disclosure requirements.[8]

In addition, the IRS rejects commentators' requests that the IRS provide a so-called "angel list" that excludes certain tax positions from Schedule UTP filing requirements. For example, some commentators requested that the following tax positions not be subject to disclosure: 1) a tax position relating to whether a foreign entity's activities in the United States constitute a permanent establishment under a treaty; 2) tax positions regarding equity versus debt classification; and 3) whether or not a transaction constitutes a tax-free combination. The IRS states that it believes exclusion of these types of tax positions from Schedule UTP reporting would be inconsistent with the purpose and objectives underlying Schedule UTP.

ELIMINATION OF DISCLOSURE OF ADMINISTRATIVE PRACTICE POSITIONS

The IRS eliminated from final Schedule UTP the requirement to disclose positions for which a reserve was not established due to an administrative practice of the IRS. Taxpayers had previously been required to check a box on draft Schedule UTP to indicate reliance upon IRS administrative practice.

COORDINATION WITH FORM 8275

The Instructions state that a taxpayer will be treated as if it filed a Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, with respect to a tax position, provided that there is a complete and accurate disclosure of such tax position on the appropriate year's Schedule UTP.[9] In the event that there is such complete and accurate disclosure, a corporation does not need to file a Form 8275 or Form 8275-R regarding the tax position in order to prevent certain accuracy-related penalties with respect to the tax position.

IRS'S REVISED POLICY OF RESTRAINT

Announcement 2010-76 was issued concurrent with final 2010 Schedule UTP and Announcement 2010-75, making changes to the IRS's policy of restraint.

Three key changes to the policy of restraint, currently located in the Internal Revenue Manual (the "I.R.M.") part 4.10.20, which deals with "Requesting Audit, Tax Accrual, or Tax Reconciliation Workpapers" during examination, are made under the Announcement and are intended to largely reassure taxpayers that the IRS is not seeking their legal analysis or risk assessments. First, the Announcement clarifies that disclosure of issues on Schedule UTP does not otherwise affect the protections afforded under the policy of restraint. Second, it clarifies that a taxpayer may redact the following information from any copies of tax reconciliation workpapers relating to the preparation of Schedule UTP that it is asked to produce during an examination: 1) working drafts, revisions or comments concerning the concise description of tax positions reported on Schedule UTP; 2) the amount of any reserve related to a tax position reported on Schedule UTP; and 3) computations determining the ranking of tax positions to be reported on Schedule UTP or the designation of a tax position as a so-called "major tax position."

Last, the Announcement adopts a policy pursuant to which the IRS will generally not seek documents that would otherwise be privileged (*e.g.*, privileged under the attorney-client privilege, the tax advice privilege in section 7525 of the Internal Revenue Code, or the work product doctrine), *even though* the taxpayer has disclosed the document to a financial auditor as part of an audit of the taxpayer's financial statements.

It is worth noting, however, that the IRS's policy of restraint with respect to privileged documents only applies "during an examination" process. Presumably, if the taxpayer seeks to litigate the issue in court, the IRS or Department of Justice would not be constrained by these policies. In addition, the IRS reserved the right to assert waiver of the noted privileges if the taxpayer has engaged in any activity or taken any action other than providing privileged documents to an independent auditor (*i.e.,* any activities which would waive the attorney-client privilege, the tax advice privilege in section 7525 of the Code, or the work product doctrine). The IRS also reserved the right to request tax accrual workpapers under IRM 4.10.20.3 when unusual circumstances exist or the taxpayer has claimed the benefits of one or more listed transactions.

TREASURY ISSUES FINAL REGULATIONS REQUIRING DISCLOSURE OF UNCERTAIN TAX POSITIONS

Final regulations were adopted on December 13, 2010 under Treasury Regulation section 1.6102-2(a) providing the IRS authority to require disclosure on Schedule UTP. Under new section 1.6012-2(a)(4), "[a] corporation required to make a return under this section shall attach Schedule UTP, Uncertain Tax Position Statement, or any successor form, to such return, in accordance with forms, instructions, or other appropriate guidance provided by the IRS." The regulations are effective for returns filed for tax years beginning on or after January 1, 2010.[10]

CONCLUSION

The IRS's recent guidance on Schedule UTP evidences that the IRS listened to and appreciated comments from the various commentators, as the IRS addressed many of the issues raised. That said, as with all new guidance areas, unanswered questions remain. For example, additional guidance surrounding the initial year reporting of multiple year positions (*e.g.,* amortization) as well as guidance surrounding the reporting of tax positions in the year in which a corporation is acquired or disposed of would be beneficial. Whether the IRS will ultimately expand Schedule UTP reporting to partnerships and tax-exempt entities also remains to be seen.

END NOTES

1 *See, e.g.,* U.S. v. Arthur Young, 465 U.S. 805 (1984); U.S. v. Deloitte & Touche USA, 623 F.Supp.2d 39 (D.D.C. 2009), *aff'd in part, rev'd in part* 610 F.3d 129 (2009); Textron Inc. v. Comm'r, 336 F.3d 26 (1st Cir. 2003).

2 2010-19 I.R.B. 668.

3 2010-41 I.R.B. 428.

4 The IRS concurrently issued Announcement 2010-76, 2010-41 I.R.B. 432 (discussed in more detail below), as well as an industry directive.

5 The Compliance Assurance Process, or "CAP," is an IRS program pursuant to which taxpayers engage in full disclosure of information concerning their completed business transactions and their proposed return treatment of all material issues. Participating taxpayers that resolve all material issues will be assured, prior to the filing of the tax return, that the IRS will accept their tax return, if filed consistent with the resolutions, such that no post-filing examination will be required. Coordinated Industry Case, or "CIC," taxpayers are typically subject to examination on a continuing basis (as opposed to CAP participants, which is essentially "real time"). CIC applies to the largest taxpayers within the Large Business and International, or "LB&I," division of the IRS, some of whom also participate in the CAP program.

6 *See UTP Aims to be Consistent with Financial Reporting Standards, IRS Officials Says,* 2010 TNT 211-1 (Nov. 2, 2010) ("Addressing several technical issues related to the UTP regime, [Edward Froelich of Morrison & Foerster LLP] said it was unclear how transition relief would be applied in situations in which issues in nonreportable years might give rise to positions taken on returns after the reporting effective date -- for example, net operating loss carryforwards. [Kathryn A. Zuba, special counsel with the IRS Office of Associate Chief Counsel (Procedure and Administration)] said the UTP reporting principle applies regardless of the pre-2010/post-2009 tax year reporting distinction. If a reserve was recorded and the position reported on a U.S. return, that position is subject to UTP disclosure, she said. However, the IRS is considering the extent to which further guidance may address issues like NOLs, she said."). *See also IRS Official Outlines Potential Areas for Guidance on Schedule UTP,* 2010 TNT 214-1 (Nov. 5, 2010) (additional guidance will likely take the form of frequently asked questions).

7 Ann. 2010-75.

8 Section 6662(i) provides for a 40 percent penalty for non-disclosure of economic substance transactions (a 20 percent penalty will otherwise apply under section 6662(b)(6)). See Notice 2010-62, 2010-40 I.R.B. 411. Under the Notice, economic substance transactions must be on either Form 8275 or 8275-R with the taxpayer's return to avoid the 40 percent penalty in section 6662(i). Form 8275 is used by taxpayers and tax return preparers to disclose items or positions, except those taken contrary to a regulation, that are not otherwise adequately disclosed on a tax return to avoid certain penalties. Form 8275-R, on the other hand, is used by taxpayers and tax return preparers to disclose positions taken on a tax return that are contrary to Treasury regulations. Taxpayers may avoid certain penalties otherwise applicable under section 6662 through disclosure on these forms, assuming their positions are reasonable. Additional disclosure requirements are provided in Notice 2010-62 for economic substance transactions which are also reportable transactions.

9 *See* Fn. 8 for a discussion on Forms 8275 and 8275-R.

10 Treas. Reg. § 1.6012-2(a)(5).

Craig L. Pichette is a partner in KPMG's Washington National Tax Practice and may be reached at *cpichette@kpmg.com.*

Michael E. Bauer is a manager in KPMG's Washington National Tax Practice and may be reached at *michaelbauer@kpmg.com.*

RESULTS OF TAX MODELING SURVEY

By Steven C. Chamberlin

The Taxation Section of the Society of Actuaries recently conducted a survey on how federal income tax is reflected in the projection work being performed. The survey focused on the projection of tax under the asset adequacy analysis required by the Actuarial Opinion and Memorandum Regulation (AOMR) as well as the risk-based capital (RBC) requirements under C-3 Phase II, which incorporate federal income tax into the determination of the Total Asset Requirement (TAR).

The goal of the survey was to see how the sophistication in this regard varies from company to company. It was also an opportunity to see if there were variances in federal income tax projection between AOMR and C-3 Phase II modeling, and also determine how much companies rely on modeling software capabilities.

Responses were consolidated at a company level, and were received from 28 companies. These were a mix of large, medium and small companies as 14 had more than $10 billion of admitted assets, eight had admitted assets of $2 to $10 billion, and six were less than $2 billion. Of the responses received, 57 percent were submitted by the appointed actuary. Although 14 percent of respondents said tax was their primary area of responsibility, all of them said they were either very or somewhat familiar with the federal taxation of life insurance companies in the United States.

The responses covered a broad spectrum of products (see Table 1). Almost all the companies modeled life insurance and fixed annuities, and nearly half included variable annuities and variable life insurance. Products reflected in the “other” category were group LTD claim reserves, disability income, health insurance and AD&D.

The survey also asked what tax rate companies applied in their models, and 75 percent of them used a 35 percent tax rate.

TABLE 1

Product lines covered in your response to the survey	Percent
Life Insurance	96%
Fixed Annuities	93%
Variable Annuities	46%
Variable Life Insurance	43%
Equity-Indexed Annuities	29%
Long Term Care	21%
Other	25%

ASSET ADEQUACY MODELS

As expected, 96 percent of the companies said that federal income tax was reflected in their asset adequacy models. The one exception said that income tax did not have a material impact on results. Of the companies that did reflect federal income tax, 75 percent said that taxable income was modeled explicitly. Most of the rest said that taxes were computed using statutory pre-tax income, which some of those companies also noted was a conservative assumption.

The survey also asked what tax rate companies applied in their models, and 75 percent of them used a 35 percent tax rate. The rest utilized a company-specific marginal rate which ranged from 17 percent (to reflect the small company deduction) to 36 percent (to incorporate state income taxes).

Reserves comprise the largest book/tax difference for most companies, so the survey also asked how tax reserves were computed in their models. Not surprisingly, 47 percent of companies performed an exact calculation by model cell, another 32 percent did an approximate calculation for model cells, and 11 percent performed seriatim reserve computations in their models. The remaining companies said the calculations varied by model cell or were approximated as statutory reserves.

Companies were also asked what other adjustments were made to taxable income and tax (see Table 2). As shown, Section 848 DAC tax adjustments were made by almost all companies while other adjustments were much less common.

TABLE 2

Other adjustments made to taxable income and tax	Percent
Section 848 DAC	89%
Capital loss carryforwards and carrybacks	22%
Ordinary loss carryforwards and carrybacks	17%
10-year spread under 807(f)	17%
Separate Account Dividends Received Deduction	17%
Tax Credits	11%
Utilization of losses in extreme scenarios	6%
Life-nonlife consolidation	6%

Potential utilization of tax losses was not considered in the projection by most companies, as 89 percent said that a marginal tax rate was applied in both positive and negative years in all scenarios. Only 5 percent of companies projected the deferred tax asset (DTA) explicitly, and 84 percent did not consider the DTA in their projection. The remaining companies made a top-side adjustment to avoid double-counting the admitted DTA or modeled the initial DTA only.

Capital gains and losses were accounted separately from ordinary income by 84 percent of the companies, but only 11 percent of companies said that investment income recognized differences between statutory and tax basis of assets. The source of the tax calculation was vendor software without modification for 63 percent of the companies, while another 32 percent used vendor software with specific modifications. One company said the vendor software had a separate tax reserve calculation available, but it was modified for run-time considerations.

Only 42 percent of companies said that a specific analysis of the tax projections is conducted as part of an overall review of the calculations. Of those companies, 88 percent said the review was performed by the valuation actuary and the rest were reviewed by the tax department.

When asked if they planned any future changes in procedures, 42 percent of companies said that their current tax projections were adequate. An additional 21 percent said that future changes depended on availability of vendor software and another 21 percent were undecided. Other companies noted that they were making changes due to model improvements or conversions, and one company noted that they may enhance the tax computation for unrealized gains on hedges and the DTA.

C-3 PHASE II MODELS

The survey also addressed treatment of federal income tax items for C-3 Phase II modeling, and 52 percent of the companies indicated that they do compute RBC under C-3 Phase II. Of those companies, 62 percent discount using the after-tax Treasury rate and 38 percent discount using the after-tax portfolio rate.

When asked how taxes are reflected in the RBC calculation, 54 percent of companies based taxes on statutory pre-tax income including the tax adjustment to TAR, 23 percent said that taxable income was modeled explicitly, 15 percent used the alternate method, and 8 percent based taxes on statutory pre-tax income only.

The responses to the remaining C-3 Phase II questions were similar to the responses received for asset adequacy analysis, except that use of the alternate method was a response for several items.

CONCLUSIONS

The results of the survey were not surprising, in that most companies modeled tax reserves and Section 848 DAC tax and generally relied on vendor software. Since asset adequacy analysis is a pass/fail test and the results of C-3 Phase II modeling have balance sheet impact, it might have been anticipated to see more refinements in the C-3 Phase II modeling. There weren't significant differences in the C-3 Phase II modeling, although the smaller number of companies responding to those questions made it more difficult to draw conclusions.

This was the first time this survey was conducted, but the section expects to repeat it in the future to assess changes in federal income tax modeling. The survey could also potentially be expanded to other projections such as embedded value, Solvency II, C-3 Phase III or wherever federal income tax modeling might have an impact.

Steven C. Chamberlin, FSA, MAAA, is a consulting actuary with Chamberlin Consulting, LLC and may be reached at *scc_61_92@mediacombb.net.*

ACLI UPDATE
LEGISLATIVE AND REGULATORY DEVELOPMENTS

By Walter Welsh and Mandana Parsazad

As usual, ACLI and its many members have been engaged with regulators and legislators as they have considered new guidance and legislation. On the legislative front, in September, Congress enacted the Small Business Lending Fund Act[1] that contained a provision to treat payments received from the partial annuitization of a non-qualified deferred annuity as payments received as annuity payments. On the regulatory front, the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") released Rev. Proc. 2010-28[2] with guidance on the applications of sections 7702 and 7702A to life insurance contracts that have mortality guarantees based upon the 2001 Commissioners' Standard Ordinary Mortality Tables ("2001 CSO"), and that may continue in force after the day on which the insured attains age 100. ACLI and its members also engaged Treasury and IRS in discussions about the applicability of the Foreign Account Tax Compliance Act [3]("FATCA") to life insurance companies and products.

PARTIAL ANNUITIZATION AND PARTIAL EXCHANGES OF NON-QUALIFIED DEFERRED ANNUITY CONTRACTS

Partial Annuitization

As noted above, Congress enacted the Small Business Lending Fund Act that contained a provision to treat payments received from the partial annuitization of a non-qualified deferred annuity as annuity payments. This provision applies annuitization rules to partial annuitization for a period of no less than 10 years.

ACLI member companies have been seeking clarification of the rules on partial annuitization for a number of years. This is a very important step in encouraging annuitization. The annuity portion will be treated as a separate contract allowing exclusion ratio treatment. The investment in the contract will be allocated *pro rata* between the annuitized and non-annuitized parts of the contract.

By its terms this provision applies to partial annuitization of life insurance contracts; the merits of partial annuitization of a life insurance contract is under analysis by our members.

Partial Exchanges

The IRS released a Private Letter Ruling on partial exchanges (PLR 201038012) in late September. In the PLR, the taxpayer was 59 ½ before the initial (external) partial exchange of his annuity contract where he instructed the company with whom he had the annuity contract to direct a portion of the cash value to another company to issue a second annuity contract. At a subsequent date, the taxpayer took a withdrawal from the original annuity. The question was whether the subsequent withdrawal invalidated the initial exchange. The IRS ruled that it did not because the taxpayer "met the condition described by Section 72(q)(2)(A): the withdrawal was made on or after the date on which Taxpayer attained age 59 ½ years."

ACLI continues efforts with the Committee of Annuity Insurers to seek guidance.

PREVAILING COMMISSIONERS' STANDARD ORDINARY LIFE VALUATION MORTALITY TABLES

Treasury and IRS issued Rev. Proc. 2010-28 on August 20 on the application of Sections 7702 and 7702A to life insurance contracts that: 1) have mortality guarantees based upon the 2001 CSO Tables; and that 2) may continue in force after the day on which the insured attains age 100. We are pleased to see that Treasury and IRS were responsive to our October 2009 request that the scope of the safe harbors be defined to apply only to contracts issued under 2001 CSO Tables. Moreover, Treasury and IRS were similarly responsive to our requests that:

- the computation rules in the safe harbor be modified consistent with the Society of Actuaries' Tax Section Task Force ("Task Force") recommendations, and
- the proposed 105 percent safe harbor be eliminated.

In Notice 2009-47, Treasury and IRS had also requested comments concerning the applicability of pre-1984 Act case law and the constructive receipt doctrine when a life insurance contract matures, by its terms, while the insured is still alive. ACLI's October 2009 submission argued that Section 7702 addressed any concerns under the *LeGierse* case regarding risk shifting, and that there should be no constructive receipt of inside build-up when an insured attains age 100; the Revenue Procedure did not comment on risk shifting or constructive receipt.

NOTICE 2010-60—APPLICABILITY OF FATCA TO LIFE INSURANCE COMPANIES AND PRODUCTS

FATCA requires increased disclosure of offshore accounts to improve tax compliance and was passed as part of the Hiring Incentives to Restore Employment Act ("HIRE" Act) in March 2010. The provisions of FATCA impose a 30 percent withholding tax on payments to "foreign financial institutions" that do not comply with information reporting requirements with respect to financial accounts U.S. taxpayers have in their institutions.

On August 20, Treasury and IRS issued Notice 2010-60[4] on FATCA; the Notice mentioned that the "definition of 'financial institution' in Section 1471(d)(5) is broad enough to encompass certain insurance companies." ACLI met with IRS and Treasury in August and October to discuss possible application of FATCA to life insurance companies and life insurance products, and submitted a comment letter in response to Notice 2010-60 on November 1. ACLI has also coordinated its efforts with insurance trade representatives internationally to help educate Treasury and IRS on why the nature of life insurance companies and their products does not implicate the potential for tax evasion behind this new reporting (and withholding) regime, and why the distinguishing features of the life insurance companies and the products they issue warrant a substantially different treatment under the FATCA rules.

END NOTES

1. The Small Business Jobs Act of 2010, P.L. 111-240. This new provision is discussed in more detail in this issue at page 1.
2. 2010-34 I.R.B. This new provision is discussed in more detail in this issue at page 10.
3. Hiring Incentives to Restore Employment Act of 2010, P.L. 111-147 (the "HIRE") Act.
4. 2010-37 I.R.B.

Walter Welsh is executive vice president, Taxes & Retirement Security at the ACLI in Washington, D.C. and may be reached at *walterwelsh@acli.com.*

Mandana Parsazad is senior counsel, Taxes & Retirement Security at the ACLI in Washington, D.C. and may be reached at *MandanaParsazad@acli.com.*

T[3]: *TAXING TIMES* TIDBITS

WATCH OUT! THE THREE-YEAR TRANSITION PERIOD FOR ADOPTING PRINCIPLE-BASED RESERVES MAY NOT APPLY TO TAX RESERVES

By Peter H. Winslow

In 2009, the National Association of Insurance Commissioners (NAIC) adopted a comprehensive revision to the Standard Valuation Law (SVL). Section 11 of the new SVL provides that minimum reserve standards are those required by a new NAIC Valuation Manual for policies issued on or after the "operative date" of the Valuation Manual. Changes to the Valuation Manual, therefore, can result in an automatic change to the reserve method specified by the NAIC for newly issued policies. This in turn can directly impact the amount of life insurance reserves for tax purposes. Under I.R.C. § 807(d)(3), the tax reserve method for a life insurance contract is the Commissioners' Reserve Valuation Method (CRVM) which is in effect on the date of issuance of the contract. If CRVM does not apply, the tax reserve method is the method prescribed by the NAIC which covers the contract as of the date of issuance. Because the Internal Revenue Code defers to the NAIC for the applicable tax reserve method as of the issue date of the contract, the "operative date" of any Valuation Manual change to the SVL method also can determine the effective date of a corresponding change to the tax reserve method. This will become an important issue when, and if, the NAIC amends the Valuation Manual to adopt Principle-Based Reserves (PBR) in VM-20 for individual life insurance.[1]

Section 11 of the SVL provides that, after the NAIC has adopted a reserve method change to the Valuation Manual, the operative date of the change will be January 1 following the date when states with 75 percent of direct premiums written have adopted the change.[2] This provision of the Valuation Manual creates an interesting cascading rule for the issue-date provision for tax reserves. Although I.R.C. § 807(d) defers to the NAIC for the applicable tax reserve method as of the issue date of the contract, the NAIC itself defers to states having at least 75 percent of direct written premiums for the implementation of its own reserve method changes. The result should be that PBR will not become effective as the tax reserve method when the NAIC initially adopts it because the NAIC's "operative date" will not yet be triggered. For contracts issued prior to the "operative date," the NAIC-prescribed method will still be the pre-PBR method until a sufficient number of states have adopted PBR.

As of the time of drafting this Tidbit, the earliest possible operative date of PBR is 2013 and in all likelihood will be much later. At its Summer 2010 Meeting, the NAIC Life and Health Actuarial Task Force formed a Regulatory Testing Subgroup which has commissioned a PBR Impact Study Report with a March 2011 deadline. Regulators will need time to consider the report and make any necessary fine-tuning to VM-20. State legislatures probably will not begin to consider possible adoption until 2012, at the earliest, and the 75 percent threshold is unlikely to be reached until 2013, 2014 or later. As currently drafted, there is a three-year transition period that would allow a life insurance company to elect not to adopt PBR for up to three years from the operative date of the Valuation Manual, meaning that companies may not need to adopt PBR until at least 2016.

Any election to delay implementation of PBR after the operative date in the Valuation Manual could cause unanticipated tax issues. Regardless of whether an election is made, once PBR becomes effective for NAIC SVL purposes, it will become the tax reserve method. Therefore, if an election is made by a company that thinks that an earlier adoption of PBR would create a hardship, the electing company may be surprised to learn that at least some of the difficulty cannot be avoided for tax reasons.

There may be some relief, however. Full implementation of PBR for tax purposes may not be necessary for those companies that elect to defer adoption of PBR for statutory reserves. VM-20 defines PBR as the aggregate net premium reserve (NPR), plus the excess, if any, of the greater of the aggregate deterministic reserve and the stochastic reserve over the aggregate NPR. At this point, it appears doubtful whether the IRS will agree that the stochastic reserve component qualifies as part of federally prescribed reserves deductible under I.R.C. § 807(d). The IRS rejected such treatment in interim guidance

CONTINUED ON PAGE 30

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *pwinslow@scribnerhall.com.*

for the stochastic CTE Amount component of Actuarial Guideline 43 (AG 43) reserves for variable annuity contracts, and is likely to take the same position for PBR.[3] Similarly, the IRS has raised concerns over whether the deterministic reserve based on a gross premium valuation methodology can be included in federally prescribed reserves for tax purposes.[4] As a result, it is possible that the IRS will recognize only the NPR portion of PBR as the federally prescribed reserve that qualifies for recomputation for tax purposes under the rules of I.R.C. § 807(d). Therefore, companies faced with implementation difficulties that elect to defer adoption of PBR for statutory reserves may obtain some relief and may need to compute only the NPR portion of PBR for tax purposes.

Another interesting tax issue could arise relating to the interplay of the statutory reserves cap in I.R.C. § 807(d)(6) with the 10-year spread rule for tax reserve changes in I.R.C. § 807(f). Reserves must be computed for tax purposes using the NAIC-prescribed method in effect as of the time the contract is issued regardless of the method used to determine statutory reserves. The amount of tax reserves, however, is capped by statutory reserves as defined in I.R.C. § 807(d)(6).[5] It is possible that statutory reserves capping could apply to a company that elects to defer adoption of PBR. Tax reserves for contracts issued after the operative date of the Valuation Manual would be computed on the basis of the NPR portion of PBR, but they could be capped by statutory reserves determined using the pre-PBR method if that method yields smaller reserve amounts. Suppose that this company, when it ultimately adopts PBR, decides to restate its statutory reserves to PBR for all of these contracts issued after the operative date. In such circumstances, the statutory reserves cap on tax reserves can shift from the pre-PBR smaller limit to the larger PBR statutory reserves. This "uncapping" potentially could bring consideration of I.R.C. § 807(f) into play.

Section 807(f) applies where there is a change in basis of computing tax reserves of a life insurance company. When applicable, it requires that the difference between the deductible insurance reserves computed under the new method and the reserves computed under the old method as of the end of the year of the change be reflected ratably over 10 years (the "10-year spread"). An unresolved issue is whether a change in annual statement reporting of reserves (that occurs without a corresponding change in federally prescribed tax reserves) is a change in basis of computing reserves or whether it is a mere change in facts to which section 807(f) does not apply. Legislative history suggests that a change to the net surrender value ordinarily will not be subject to section 807(f) presumably because the change is a mere change in facts relating to contract benefits. Many tax practitioners believe that this legislative history applies by analogy to the change in the statutory reserves cap. It is arguable, however, that the computation of statutory reserves is a tax reserve method to the extent the statutory reserves cap is applicable and a change in that method gives rise to the application of the 10-year spread rule of section 807(f). A similar issue arose when AG 43 was adopted. Unlike PBR, AG 43 has retroactive effective for statutory purposes and applies to policies issued before its effective date. As a result, statutory reserves for contracts issued prior to Dec. 31, 2009, are computed using AG 43, but tax reserves are not. In Notice 2010-29,[6] the IRS provided interim guidance that concluded that a 10-year spread would apply to any statutory reserves capping change arising from the transition to AG 43. But, the IRS and Treasury Department also have made it clear that the 10-year spread in Notice 2010-29 is not identical to what would have been required under I.R.C. § 807(f) and that no inference should be taken from the notice as to whether I.R.C. § 807(f) applies to other capping or uncapping situations.[7] Resolution of this issue will have to wait for another day.

END NOTES

1. Changes to the net premium reserve in Section 3 of VM-20 will apply only to term policies and universal life insurance with secondary guarantees.
2. *See also* Valuation Manual VM-00; VM-20, Section 1.
3. IRS Notice 2010-29, 2010-15 I.R.B. 547.
4. IRS Notice 2008-18, 2008-5 I.R.B. 363.
5. Statutory reserves are defined in I.R.C. § 807(d)(6) as the aggregate amount set forth in the annual statement with respect to items described in I.R.C. § 807(c). Statutory reserves do not include any reserve attributable to a deferred and uncollected premium if the establishment of such reserves is not permitted under I.R.C. § 811(c).
6. 2010-15 I.R.B. 547.
7. *Attorney-Actuary Dialogue on Notice 2010-29*, 6 TAXING TIMES 23 (Sept. 2010).

PLR201045019: ADDING INVESTMENT OPTIONS TO IN-FORCE CONTRACTS

By Kory J. Olsen

In a recent Private Letter Ruling (PLR201045019), the Internal Revenue Service (IRS) ruled that under the facts presented, the addition of Investment Options to in-force life insurance contracts is not a deemed exchange and there is no new "issue date" for purposes of IRC Sections 7702, 7702A and 807, nor would it require an adjustment in the computation of the Section 7702 or 7702A limits.

The PLR request was based on an Indexed Universal Life Insurance contract with multiple Investment Options. The Investment Options determine the interest crediting rate based on the change in an external equity index. The contract entitles taxpayer to add or cease to offer Investment Options at any time. It was represented that the addition of the Investment Option will not change any benefits provided under the contract.

Essentially, the request was for three issues: a) does the addition of the Investment Option produce a "deemed exchange"; b) is it an "adjustment event" under Section 7702(f); and c) is it a "material change" under Section 7702A(c)?

To answer the "deemed exchange" question, the ruling looked at the legislative history of Section 7702 contained in the Senate Committee Report, the legislative history of Section 7702A contained in the Conference Report, "Cottage Savings Assoc. v. Commissioner," Rev. Rul. 2003-19 and Notice 2006-95. Specifically, the PLR referenced the determination of "issue date" for Section 7702, "entered into" for Section 7702A, the "materially different" criteria and the example provided in *Cottage Savings*. The PLR noted that in Rev. Rul. 2003-19 demutualization had no effect on the issue date for the policy for Sections 7702 and 7702A. The conclusion was that when these authorities are "read together," the addition of the Investment Option did not produce a deemed exchange.

The IRS did not use this opportunity to elaborate on the important factors to use to identify a "deemed exchange" as applied to life insurance, leaving continued uncertainty in this area.

In the determination of whether there was an adjustment event under Section 7702(f)(7), the PLR looked at the policy benefits. The addition of the Investment Option does not change any benefits provided under the contract. Also, the guaranteed rate under the Investment Option did not exceed the statutorily prescribed rates of 4 percent or 6 percent. Based on these factors, the conclusion was that the addition of the Investment Option would not be an adjustment event.

Regarding the "material change" under Section 7702A, this ruling looked to what was changing on the contract compared to what was used in the previous determination of the 7702A limits. With the addition of the Investment Option, there would be no change in benefits or other terms of the contract that were not previously reflected in the calculation of the 7702A limit. Hence, there was not a material change.

In summary, the IRS ruled:

1. The addition of the new Investment Option will not create a new "issue date" for Section 7702.
2. The addition of the new Investment Option will not cause a deemed exchange for purposes of determining limits under Section 7702A.
3. The addition of the new Investment Option will not create a new "issue date" for Section 807, nor cause the company to recompute its tax reserves.
4. The addition of the new Investment Option will not require an adjustment in the guideline single or level premium limits under Section 7702(f)(7)(A).
5. The addition of the new Investment Option will not require an adjustment in the computation of the cash value accumulation test limits under Section 7702(f)(7)(A).
6. The addition of the new Investment Option will not require a recomputation of the Section 7702A limits under Section 7702A(c)(3)(A).

Kory J. Olsen,
FSA, CERA, MAAA, CFA
is an actuary with Pacific Life Insurance Company and may be reached at kory.olsen@pacificlife.com.

SOCIETY OF ACTUARIES Taxation Section

475 N. Martingale Road, Suite 600
Schaumburg, Illinois 60173
p: 847.706.3500 f: 847.706.3599
w: *www.soa.org*

Taxing TIMES

Non Profit Org
U.S. Postage
PAID
Carol Stream, IL
Permit No 475