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From the Chair My View for the Year Ahead

By Thomas Edwalds

I want to thank Tony Litterer for his service as the chairperson of the Taxation Section Council and for mentoring me and preparing me for this role.

I feel deeply honored to be starting my term as the chairperson of the Taxation Section Council. My motto for the year is “First, do no harm.” This newsletter, *TAXING TIMES*, is generally regarded as one of the best newsletters published by the Society of Actuaries (SOA) and is read and referenced by many outside of the actuarial profession. Our sessions at major SOA meetings have earned “best session” awards several times within the past couple of years. Our webinars draw sizeable audiences and get high marks for quality. I intend to do what I can to make sure that this section continues to maintain this record of accomplishment, which mostly means that I will let the people who have produced these great results continue to do what they have been doing and make sure that they get the recognition that they deserve. My thanks to all of the volunteers who have helped this section achieve these excellent results.

A challenge that we will address in 2020 is the need to attract new members, particularly younger members. In December I had the pleasure of attending the Fellowship Admission Course banquet, where my daughter received her designation as a fellow of the Society of Actuaries. (I just had to work that into this column.) At dinner, I suggested to the new FSAs at our table that they should join the Taxation Section and consider running for the section council. They seemed to be taken aback by the suggestion, and



they mentioned the sections that they had joined (mostly Financial Reporting and/or Product Development). I pointed out that few actuaries work primarily on tax issues, but that many need to stay current and understand the implications of tax regulations for product development and company profitability.

I do not know if any of these new FSAs will actually join the Taxation Section, but it is clear from my conversation with them that we need to let actuaries know that membership in the Taxation Section is not restricted to an elite group of experts. If it were, I could not have joined!

I am looking forward to serving the members of the Taxation Section this year, and I hope that it will be a year of growth in membership. I hope to get the chance to meet many of you, and I hope that you will consider getting involved more substantially with the Taxation Section. We need ideas for session and webcast topics, and we need volunteers to help in ways both big and small. Anything you can do to help would be greatly appreciated! ■

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Treasury Issues Proposed Rules for Determining Active Income of Certain Foreign Insurance Companies

By Jean Baxley and Jay Riback

On July 11, 2019, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “IRS”) released REG-105474-18, Guidance on Passive Foreign Investment Companies (the “Proposed Regulations”). The Proposed Regulations provide guidance for determining whether the activity of certain foreign corporations is excepted from the Passive Foreign Investment Company (“PFIC”) regime through the active conduct of an insurance business exception of Internal Revenue Code (“I.R.C.,” the “Code”) § 1297(b)(2)(B).¹ The Proposed Regulations withdraw the proposed regulations issued April 24, 2015² (“the 2015 Proposed Regulations”). The Proposed Regulations were issued in response to changes to the PFIC rules under the Tax Cuts and Jobs Act (Pub. L. No. 115-97) (“TCJA”), specifically, enactment of § 1297(f), which defines a “qualifying insurance corporation” for purposes of the active conduct exception.³

This article provides a brief historical background on the PFIC rules and summarizes the insurance-relevant portions of the Proposed Regulations, as well as the issues and concerns raised in industry comments solicited under the Proposed Regulations.

BACKGROUND

The PFIC regime was introduced to prevent U.S. persons from obtaining indefinite deferral of U.S. tax on investment income earned through investments in foreign corporations primarily engaged in passive investing activities. Under the PFIC rules, certain minority U.S. shareholders of foreign entities deemed to be passive investment vehicles must pay tax—or interest on tax that would otherwise be owed—on “excess” distributions and any gain on disposal of their interest in the PFIC. Certain elections are available to taxpayers to immediately include PFIC income or unrealized appreciation of PFIC stock in U.S. taxable income rather than incur punitive tax and interest charges resulting from deferring U.S. taxation until earnings are

distributed or the stock is disposed. Given the large amount of seemingly passive investments that most insurance companies hold to pay out claims, the PFIC rules could cause U.S. investors in foreign insurance companies to be treated as owning a PFIC interest, despite such companies not being mere passive investment vehicles. To prevent this result, the Code provides an exception to the PFIC regime for investment income “derived in the active conduct of an insurance trade or business” by a company predominantly engaged in an insurance business that would be taxable as an insurance company were it a domestic corporation.⁴ The IRS and Treasury issued the 2015 Proposed Regulations to provide guidance as to what types and level of activities would satisfy the active conduct requirements, but the proposed guidance was never finalized.

The TCJA introduced additional statutory hurdles to qualification under the active insurance exception, primarily through the requirement that any corporation satisfying the exception must be a Qualifying Insurance Corporation (“QIC”) as defined in newly added I.R.C. § 1297(f).⁵ Pursuant to § 1297(f), for a corporation to qualify as a QIC, its “applicable insurance liabilities” must exceed 25 percent of its total assets as reported on the corporation’s “applicable financial statement” for its most recent year.⁶ The Code’s definition of applicable insurance liabilities differs from the common conception of insurance liabilities within the insurance industry, defining them narrowly as “loss and loss adjustment expenses” and “reserves (other than deficiency, contingency, or unearned premium reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks.”⁷ Notably, this definition excludes unearned premium reserves and other liabilities commonly carried by insurance companies in their capacity as insurers from the definition. The Code establishes an alternative test that lowers the liability threshold from 25 percent to 10 percent for taxpayers whose failure to satisfy the 25 percent standard is “due solely to runoff-related or rating-related circumstances involving such insurance business.”⁸

Section 1297(f) limits insurance liabilities for the purpose of either test to the lesser of (1) the amount reported to the “applicable regulatory body” in the applicable financial statement, (2) the amount required by law or regulation or (3) as otherwise determined by regulations prescribed by the Secretary.⁹ An applicable financial statement refers to, in descending order, generally accepted accounting principles (“GAAP”) financials, IFRS financials or the local insurance annual statement. If a company prepares more than one of these reports, the first listed is deemed to be “applicable.”¹⁰ An applicable insurance regulatory body is defined as “the entity established by law to license, authorize, or regulate such business” and to which the applicable financial statement is provided.

THE PROPOSED REGULATIONS

The Proposed Regulations contain several new provisions relevant to the PFIC active conduct exception. These changes can be thought of in three broad categories:

1. regulations defining the active conduct of an insurance trade or business, including the introduction of the new “active conduct percentage” test;
2. rules clarifying the requirements for qualification as a QIC; and
3. other changes to the PFIC insurance regime.

Each of these three categories will be addressed in turn.¹¹

Active Conduct and the Active Conduct Percentage Test

The most significant change in the Proposed Regulations was the introduction of the all-or-nothing “active conduct percentage” test. The test is expected to make it significantly more difficult for insurance companies to avoid PFIC categorization and was met with a largely negative response from commenters. The test measures the ratio of personnel costs incurred by employees of the QIC (and certain related companies) relative to total personnel costs. If the active conduct percentage is 50 percent or greater, all income of the QIC is deemed to be active. If the active conduct percentage is below 50 percent, all income of the QIC is deemed passive.¹² The active conduct rule provides that the personnel costs of a related company may be included in the numerator of the 50 percent test, provided a three-prong control test is satisfied.¹³

The numerator of the active conduct percentage is the aggregate amount of expenses for services of the officers and employees of the QIC (or eligible related entities) related to the production or acquisition of premiums and investment income on assets held to meet its obligations under the insurance contracts entered into by the QIC, including amounts reasonably allocated thereto.¹⁴ The denominator is essentially defined as the numerator plus analogous costs paid to persons that are not employees of the QIC or a related company.¹⁵

The bright-line active conduct test marks a significant departure from the 2015 Proposed Regulations. Under those rules, the determination of whether an insurance company participated in an active trade or business was made under a generalized facts and circumstances test. The drafters of the new Proposed Regulations indicated that a bright-line test related to personnel costs was appropriate, as the percentage of activities performed by employees of the QIC (or related companies) is a reasonable proxy for how actively the QIC engages in the insurance business.¹⁶



The Proposed Regulations inclusion of the officers and employees of related entities for the purposes of the active conduct test represents an expansion of potential service providers from the 2015 Proposed Regulations, which contemplated only employees of the entity itself in the active conduct analysis.¹⁷ A three-part test must be satisfied for this purpose:

1. **Ownership.** Either the QIC must own 50 percent of the vote and value (for a corporation) or capital and profits interest (for a partnership) of the entity, or more than 80 percent of the vote and value or capital and profits interest of both the QIC and the related entity must be owned by a common parent.¹⁸
2. **Oversight and supervision.** The QIC must exercise regular oversight and supervision over the services performed.¹⁹
3. **Payment.** The QIC must either (1) directly pay all the compensation of the other entity’s officers and employees attributable to the insurance services, (2) reimburse the other entity for the portion of its expenses with a profit markup as appropriate or (3) pay arm’s length compensation on a fee-related basis to the other entity for the insurance services provided.²⁰

QIC Clarifications

Aside from the active conduct percentage test, the Proposed Regulations provide several additional rules and clarifications defining what kind of corporation constitutes a QIC.

Similar to the Code itself, the Proposed Regulations deviate from common industry parlance in defining applicable insurance liabilities. The Proposed Regulations define applicable insurance liabilities as the sum of “[o]ccurred losses for which the foreign corporation has become liable but has not paid before the end of the last annual reporting period ending with or within the taxable year,” “unpaid expenses . . . of investigating and adjusted unpaid losses” described previously and “[t]he

aggregate amount of reserves (excluding deficiency, contingency or unearned premium reserves) held for future, unaccrued health insurance claims and claims with respect to contracts providing coverage for mortality or morbidity risks.”²¹ Total assets are defined as “the aggregate end-of-period value of the real property and personal property that the foreign corporation reports on its applicable financial statement for the last annual accounting period ending with or within the taxable year.”²²

The Proposed Regulations further provide that the amount of applicable insurance liabilities may not exceed the lesser of (1) the amount shown on the most recent applicable financial statement; (2) the minimum amount required by the applicable insurance regulatory body; and (3) the amount shown on the most recent U.S. GAAP or IFRS financials, provided such financials were not prepared for financial reporting purposes.²³ To the extent that a financial statement not prepared under GAAP or IFRS does not discount losses on an economically reasonable basis, the foreign corporation must reduce its applicable insurance liabilities to reflect discounting that would apply under either U.S. GAAP or IFRS.²⁴ An anti-abuse rule is provided whereby a foreign corporation that ceases to prepare financials in accordance with its applicable method absent a non-tax business purpose will be treated as having no applicable insurance liabilities for purposes of the QIC test.²⁵

Taxpayers that fail to satisfy the 25 percent test may still qualify as a QIC under an alternative facts and circumstances test, provided that applicable insurance liabilities constitute more than 10 percent of the company’s total assets, the corporation is predominantly engaged in an insurance business and the failure to satisfy the 25 percent test is due solely to runoff-related or rating-related circumstances. The same definitions and limitations that apply to the 25 percent test similarly apply to the 10 percent test.²⁶ In this section, the Proposed Regulations provide clarity as to what constitutes being “predominantly engaged in the insurance business” and what constitutes runoff and ratings-related circumstances, as well as providing procedures for making the alternative test election.

The Proposed Regulations provide factors to be considered when determining whether a company is predominantly engaged in an insurance business as well as specific patterns that would cut against such a finding.²⁷ Facts and circumstances to be considered include claims payment patterns, loss exposure of the company, percentage of gross receipts constituting premiums and the number and size of insurance contracts of the foreign corporation. Examples of facts that cut against such a finding include a small number of insured risks with low likelihood of occurrence but large potential costs, employees and agents focused to a greater degree on investment activities, and low loss exposures.

With regard to runoff-related circumstances, the Proposed Regulations indicate that a company seeking this status must have adopted a plan of liquidation or termination under the supervision of the company’s regulator to qualify for this status—a narrow reading of the insurance concept of runoff.²⁸ A company is deemed to satisfy the rating-related circumstances if “[t]he 25 percent test is not met as a result of the specific requirements with respect to capital and surplus that a generally recognized credit rating agency imposes” and it “complies with the requirements of the credit rating agency in order to maintain the minimum credit rating required for the foreign corporation to be classified as secure to write new insurance business for the current year.”²⁹

The Proposed Regulations also provide procedures that foreign corporations must follow to qualify for the alternative facts and circumstances test, as well as the procedures U.S. persons must undertake to make such an election. Under these rules, a foreign corporation must provide the owner a statement or release a public statement indicating they satisfy the alternative test and the U.S. person must obtain information from the foreign corporation proving as much prior to making the election.³⁰ To elect qualification under the alternative facts and circumstances standard prior to the regulations being finalized, the U.S. person must file a limited-information Form 8621.³¹

Other Provisions

Other notable provisions of the Proposed Regulations include the following:

- **Timing.** The Proposed Regulations apply prospectively (*i.e.*, to taxable years beginning on or after final regulations are published in the Federal Register). Prior to finalization, taxpayers may apply the rules as if they were final, provided they are applied consistently.³²
- **Definition of insurance business and investment activities.** The Proposed Regulations define an insurance business as the business of issuing insurance and annuities or reinsuring risks underwritten by other insurance companies (or both).³³ The definition also includes the investment activities and administrative services required to support those insurance contracts.³⁴ Investment activities are any activities that generate income from assets to meet the QIC’s insurance obligations.³⁵
- **Treatment of income and assets of look-through subsidiaries and look-through partnerships held by a QIC.** The Proposed Regulations provide that certain items of income and assets that are passive in the hands of a look-through subsidiary or look-through partnership may be treated as active by a QIC.³⁶ Generally, if income or assets are passive

in the hands of a look-through entity, they are treated as passive.³⁷ However, the income and assets of a QIC are tested to determine if they qualify for the insurance exception. The assets and liabilities of the look-through entity must be included in the applicable financial statement of the foreign corporation for purposes of the 25 percent test and 10 percent test for this rule to apply.³⁸

- **Qualifying Domestic Insurance Corporations.** Income and assets of Qualifying Domestic Insurance Corporations (“QDICs”) are not treated as passive.³⁹ A QDIC is a domestic corporation that is subject to tax as an insurance company under Subchapter L and is subject to Federal income tax on its net income. This rule is intended to address certain structures where a tested foreign corporation owns a domestic insurance corporation.
- **No double counting.** Nothing permits any item to be counted more than once (for example, for determining a reserve or an applicable insurance liability for purposes of the 25 percent test and the 10 percent test).⁴⁰

INDUSTRY COMMENTS

The IRS and Treasury solicited comments on a variety of issues addressed in the Proposed Regulations and received roughly two dozen comment letters.⁴¹ These fall into a few broad categories:

- **Active conduct.** Response to the new active conduct rules, particularly the active conduct percentage test, was largely negative. Numerous commenters called for the outright elimination of the test or relegation of the test to a safe harbor in the final regulations. The Reinsurance Association of America (“RAA”) commented that “[t]he percentage test places excessive emphasis on the size of staff, while excluding costs of essential functions routinely performed by independent agents, brokers, and investment advisors, and has little bearing on the key metric of an insurance company, which is the assumption of insurance risk. This distorted measurement could result in well established companies being improperly classified as PFICs and should be deleted.” The American Bar Association (“ABA”) highlighted definitional ambiguities in the regulations, unreasonable compliance burdens for U.S. shareholders and the harsh cliff effect of an all-or-nothing test in calling for the elimination of the active conduct percentage test. The ABA proposed that if the test is retained, final regulations should include an alternative facts and circumstances test that could be satisfied by a showing that the failure to meet the 50 percent threshold is driven by “any practical business reason.” Other commenters, including the American Council of Life Insurers (“ACLI”), support retaining the test only as a safe harbor, with a facts and circumstances determination serving as the general test.

- **Related parties.** Commenters indicated that the inclusion of related parties in the active conduct analysis represented an improvement from the 2015 Proposed Regulations. However, some called for the definition to be expanded to include activities of third parties while others called for revisions to the three-pronged control test included in the Proposed Regulations.
- **Alternative test.** Numerous commenters requested revisions to the Proposed Regulations addressing “rating-” or “runoff-” related circumstances to provide clarity and to ensure the regulations more closely adhere to commonly accepted industry understanding of those situations. Several commenters requested that deemed or automatic elections be made in the case of de minimis or minority shareholders to lessen the compliance burden on such shareholders under certain circumstances.
- **Issues regarding Applicable Insurance Liabilities.**
 - **Terminology and the definition of loss.** Several commenters requested clarifications of the definition of losses as defined in the Proposed Regulations. In particular, commenters disapprovingly noted the use of the undefined, non-industry term “occurred losses” and recommended substituting the term “unpaid loss” as defined in § 832. Several commenters similarly recommended aligning the definitions of losses and related expenses in the regulations with those already included either in Subchapter L of the Code or with respect to GAAP, IFRS or insurance financial statements.
 - **Limitations on reserves.** A number of commenters also suggested changes or clarifications regarding limitations on reserves as set out in the Proposed Regulations. For example, several commenters expressed concern with the relatively vague requirements surrounding the mandatory discounting of reserves that are not discounted “on an economically reasonable basis” on the applicable financial statement.
- **Applicable financial statements.** The ABA called for the removal of the rules referencing financial statements prepared for other than “financial reporting purposes” and disallowing a taxpayer from changing their method of accounting absent a non-tax business purpose. A few commenters objected to the rule, which provides that the assets and liabilities of a look-through subsidiary can be considered only if they appear on the applicable financial statement of a QIC.

- **Qualifying Domestic Insurance Corporations.** A number of commenters, including the ABA, ACLI and RAA, called for changes to the QDIC rules that may cause foreign companies that would not otherwise be treated as PFICs to become PFICs.
- **Interplay with I.R.C. § 954(i).** A number of commenters suggested that the regulations should be revised to provide that income from an active insurance business that is excepted from foreign personal holding company income (“FHPCI”) under § 954(i) should apply in addition to the insurance exception under § 1297(b)(2)(B).
- **Timing.** Several commenters called for delaying the mandatory implementation of the rules beyond the date the final regulations are published in the Federal Register due to the complexity and uncertainty surrounding the rules.

announced timeline for the issuance of revised or finalized PFIC regulations. In their comments, the ABA took the unusual step of recommending that the IRS and Treasury consider issuing a second round of proposed regulations “due to the number and complexity of the issues addressed in the Proposed Regulations.” Given this recommendation and the sheer breadth and depth of comments from other interested parties, it may be some time before final PFIC guidance is issued. ■

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WHAT’S NEXT?

The IRS canceled a public hearing on the Proposed Regulations scheduled for Dec. 9, 2019, as no public commenters requested the opportunity to speak. There is no current publicly

ENDNOTES

- References to the I.R.C. or the Code are to the Internal Revenue Code of 1986, as amended through the date of this writing.
- REG-108214-15.
- “An act to provide for reconciliation to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” Pub. L. No. 115-97, enacted Dec. 22, 2017.
- See current and former I.R.C. § 1297(b)(2)(B).
- I.R.C. § 1297(b)(2)(B).
- I.R.C. § 1297(f)(1)(B).
- I.R.C. § 1297(f)(3)(A).
- I.R.C. § 1297(f)(2).
- I.R.C. § 1297(f)(3)(B).
- I.R.C. § 1297(f)(4)(A).
- The Proposed Regulations also made changes to certain non-insurance provisions that are beyond the scope of this article.
- Prop. Reg. § 1.1297-5(c)(1).
- Prop. Reg. § 1.1297-5(c)(3)(ii).
- Prop. Reg. § 1.1297-5(c)(4)(i)(A).
- The Proposed Regulations indicate that ceding commissions should not be included in the numerator or the denominator.
- Guidance on Passive Foreign Investment Companies, 84 Fed. Reg. 33120 (July 11, 2019) (to be codified at 26 C.F.R. pts. 1291, 1297, & 1298) at 33135.
- Id.*
- Prop. Reg. § 1.1297-5(c)(3)(ii)(A).
- Prop. Reg. § 1.1297-5(c)(3)(ii)(B).
- Prop. Reg. § 1.1297-5(c)(3)(ii)(C).
- Prop. Reg. § 1.1297-4(f)(2).

- Prop. Reg. § 1.1297-4(f)(7).
- Prop. Reg. § 1.1297-4(e). See discussion of § 1297(f) under Background for ordering rules for applicable financial statements.
- Prop. Reg. § 1.1297-4(e)(3).
- Prop. Reg. § 1.1297-4(e)(4).
- Guidance on Passive Foreign Investment Companies, 84 Fed. Reg. 33120 (July 11, 2019) (to be codified at 26 C.F.R. pts. 1291, 1297 & 1298) at 33134.
- Prop. Reg. § 1.1297-4(d)(2).
- Prop. Reg. § 1.1297-4(d)(3).
- Prop. Reg. § 1.1297-4(d)(4).
- Prop. Reg. § 1.1297-4(d)(5).
- Id.*
- Guidance on Passive Foreign Investment Companies, 84 Fed. Reg. 33120 (July 11, 2019) (to be codified at 26 C.F.R. pts. 1291, 1297 & 1298) at 33161.
- Prop. Reg. § 1.1297-5(c)(2).
- Id.*
- Prop. Reg. § 1.1297-5(h)(2).
- Prop. Reg. § 1.1297-5(f).
- Guidance on Passive Foreign Investment Companies, 84 Fed. Reg. 33120 (July 11, 2019) (to be codified at 26 C.F.R. pts. 1291, 1297 & 1298) at 33135.
- Prop. Reg. § 1.1297-5(f)(2).
- Prop. Reg. § 1.1297-5(d) and Prop. Reg. § 1.1297-5(e)(2).
- Prop. Reg. § 1.1297-5(g).
- Comments regarding non-insurance changes in the Proposed Regulations are beyond the scope of this article.



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Final Regulations Under Sections 101 and 6050Y

By Craig Springfield and Kristin Norberg

Authors' note: As the following article describes, the final regulations published on Oct. 31, 2019, provided either an exemption or an extended deadline for information reporting requirements related to certain transactions occurring from Jan. 1, 2018, through Oct. 31, 2019. While this article was in the editing and production process, on Dec. 12, 2019, the Treasury Department and the Internal Revenue Service ("IRS") released "corrections" to the final regulations, extending these relief provisions to additional transactions and making certain other changes. See 84 Fed. Reg. 68042-68043 (Dec. 13, 2019).

The final regulations under section 6050Y, as corrected, apply to reportable policy sales made, reportable death benefits paid, and any notice of a transfer to a foreign person received, in each case after Dec. 31, 2018, thus extending the original exemption for 2018 to include notice of a transfer to a foreign person. Additionally, the extended reporting deadlines (including the extended Feb. 28, 2020, deadline for insurers to furnish Forms 1099-SB and 1099-R to recipients) apply for reportable policy sales and payments of reportable death benefits occurring throughout calendar year 2019, as well as to any notice of a transfer to a foreign person received during calendar year 2019, thus extending the original transition relief to include notice of a transfer to a foreign person and to include November and December activity.

Members of the life insurance industry greatly appreciate the IRS and Treasury's willingness to reconsider the details of these relief provisions in order to facilitate a successful implementation of the new reporting regime.

On Oct. 25, 2019, the Treasury Department ("Treasury") issued Treasury Decision 9879, which provides final regulations under sections 101 and 6050Y¹ regarding transfers for value of life insurance policies and tax reporting requirements with respect to such transfers.² We previously provided a detailed discussion of the proposed regulations in the October 2019 issue of *TAXING TIMES*. The present article focuses on revisions that were made to the proposed regulations, many of which were in response to comments submitted to the Internal Revenue Service ("IRS") and Treasury by the life insurance industry and other interested parties.

As background, the transfer-for-value rule of section 101(a)(2) generally limits the exclusion of the death benefit from taxable income where a life insurance policy is transferred for value to the sum of the consideration paid for the policy by the transferee/acquirer, including premiums that are paid by the transferee/acquirer after the transfer. However, two exceptions set forth in sections 101(a)(2)(A) and (B) provide relief from this rule where the transferee's tax basis in the policy is determined in whole or part by reference to such basis in the hands of the transferor (the "Carryover Basis Exception") and where the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer (the "Related-Party Transfer Exception"). Section 101(a)(3)(A), however, which was enacted by the Tax Cuts and Jobs Act of 2017 ("TCJA")³ provides that these two exceptions will not apply in the case of a transfer that is a "reportable policy sale" ("RPS"). For this purpose, an RPS is defined by section 101(a)(3)(B) as "the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract."⁴

The TCJA also enacted section 6050Y, which imposes reporting requirements on the acquirer of a life insurance policy or interest therein in an RPS, on the issuer of a policy receiving notice of an RPS or of the transfer of a policy to a foreign person, and on the payor of reportable death benefits under a policy that previously was involved in an RPS.

SECTION 6050Y REPORTING REQUIREMENTS

As described in our earlier article, the proposed regulations provided additional detail on the three reporting requirements under section 6050Y. Numerous comments were submitted in response to the proposed regulations, and the discussion in this article addresses the changes made in the final regulations with respect to those comments, as well as certain areas where requested changes were not made. The discussion first covers more general aspects that affect multiple reporting requirements (such as applicability dates and gratuitous transfers), followed by other details specific to one of the reporting requirements. Our earlier article should be referenced for aspects of the regulatory guidance that were not altered.

Applicability Dates and Transition Relief

One of the major changes made in the final regulations was to eliminate the reporting requirements under section 6050Y for RPSs made and reportable death benefits paid during calendar year 2018. The final regulations apply only to such transactions occurring after Dec. 31, 2018.⁵ Further, death benefits paid in future years are subject to the reporting requirements of Treas. Reg. section 1.6050Y-4 only if the contract or an interest therein

was transferred in an RPS after Dec. 31, 2018; *i.e.*, contracts or interests acquired during 2018 in a transaction that meets the statutory definition of an RPS in section 101(a)(3)(B) remain exempt from the section 6050Y(c) reporting of subsequent reportable death benefits in future years, unless another RPS occurs after Dec. 31, 2018.⁶

Additionally, for RPSs made and reportable death benefits paid Jan. 1 through Oct. 31, 2019, the deadlines for furnishing Form 1099-SB (or a substitute statement) to the seller and for furnishing Form 1099-R (or a substitute statement) to the recipient of reportable death benefits were extended to Feb. 28, 2020 (120 days, rather than 90 days in the proposed regulations, after the date the final regulations were published in the Federal Register), in response to comments received.

It is worth noting that the final regulations did not refer to transfers to a foreign person in the discussions of applicability dates and transition relief, so these would apparently still be subject to reporting on Form 1099-SB for transfers occurring in 2018 and to the standard deadlines (which, of course, have already passed for transfers occurring in 2018).⁷ As of the date of this writing, personnel at the IRS have indicated informally that the omission of transfers to a foreign person in these provisions was not intentional and could be remedied; readers are urged to monitor subsequent guidance, including potential amendments to the final regulations, for this item.

In addition to the transition relief for transactions that occurred prior to issuance of the final regulations, several commenters had requested ongoing penalty relief in various forms (such as permission for an indirect acquirer to make a “good faith effort” to comply with Form 1099-LS requirements if the direct owner of a policy does not provide sufficient information for full compliance, or a checkbox an issuer could use to notify the IRS that a Form 1099-SB was being filed late because Form 1099-LS was received late). These requests were not included in the final regulations because Treasury and the IRS viewed the existing relief procedures, such as demonstrating reasonable cause under section 6724(a), to be adequate.⁸

Reporting for Gratuitous Transfers

As discussed later in this article, the final regulations did not adopt a recommended change to exclude gratuitous transfers from the definition of an RPS. However, the preamble included a lengthy discussion of the section 6050Y obligations with respect to gratuitous transfers, reaching the practical result that no reporting is required under any of the three components of section 6050Y if the only RPS that occurs with respect to a contract is a gratuitous transfer to a U.S. person:⁹

- The preamble notes that the acquirer in a gratuitous transfer is not required to perform the Form 1099-LS reporting because such reporting is only required with respect to an RPS payment recipient.¹⁰ The donor of the contract in a gratuitous transfer receives no payment and therefore is not an RPS payment recipient. Thus, there is no Form 1099-LS reporting and no RPS statement to be sent to the issuer.
- As a result, whether or not the gratuitous transfer meets the technical definition of an RPS, the issuer would not have been notified via an RPS statement, and thus no Form 1099-SB reporting is triggered.¹¹
- Further, since the issuer would not have been notified that an RPS had occurred, it would not be on notice that death benefits paid under the contract are reportable. The final regulations added an exception to relieve the payor from the Form 1099-R death benefit reporting obligation in this situation: Treas. Reg. section 1.6050Y-4(e)(3) provides that if a payor of reportable death benefits never received, and has no knowledge of any issuer having received, an RPS statement with respect to the interest in the contract, then the payor is not required to file or furnish a Form 1099-R under section 6050Y(c) and Treas. Reg. section 1.6050Y-4 for the death benefits paid. (It is implied that the beneficiary is responsible for properly reporting any taxable portion of the death benefits received, whether or not the payor is required to report under section 6050Y(c).)

Reporting for 1035 Exchanges

As will be discussed later in connection with changes to the regulations under section 101, the final regulations treat the issuance of a new contract in a 1035 exchange as an RPS if the owner of the new contract has no substantial family, business, or financial relationship with the insured.¹² The final regulations provide that the acquirer of the new contract in this situation must provide an RPS statement (*i.e.*, Form 1099-LS or substitute) to the insurance company issuing the new contract, although the acquirer would have no corresponding filing obligation with the IRS.¹³

It appears this could create a new and unexpected process whereby insurance companies may receive Form 1099-LS in connection with a new business case, when there has been no actual transfer of the newly issued contract. The insurance company is not required to file or furnish Form 1099-SB in this situation,¹⁴ as there has been no actual transfer, but would need to identify the policy on its administrative systems as having had an RPS, triggering the death benefit reporting requirement under section 6050Y(c) and Treas. Reg. section 1.6050Y-4.

Indemnity Reinsurance and the Definition of “Issuer”

As noted in our article in the October 2019 issue of *TAXING TIMES*, the proposed regulations contained a broad definition of “issuer,” explicitly including a reinsurance company that has reinsured on an indemnity basis all or a portion of the risks under a contract, apparently imposing reporting requirements on a party that does not administer the contract and would not generally have access to the required information to be able to report. Despite comments submitted on this topic, the definition is substantially unchanged in the final regulations.¹⁵ However, the preamble to the final regulations discusses the commenter’s concerns and outlines the provisions of the final regulations that, in practice, would limit the reporting obligations of an indemnity reinsurer.¹⁶

- As in the proposed regulations, the RPS statement is to be sent to the “6050Y(a) issuer,” which is the issuer responsible for administering the life insurance contract.¹⁷ Thus, indemnity reinsurers that do not administer the reinsured contracts should not receive a Form 1099-LS in the first place.
- As in the proposed regulations, the Form 1099-SB reporting is the responsibility of the “6050Y(b) issuer,” which is the issuer that receives an RPS statement or notice of a transfer to a foreign person. Normally this would be the insurer that actually administers the contract; however, if for some reason a reinsurer receives notice of a transfer to a foreign person, it can transfer the Form 1099-SB reporting responsibility back to the contract administrator by providing the notice to them, along with any available information necessary for such reporting.¹⁸
- In either case (RPS statement or notice of transfer to a foreign person), the proposed and final regulations both provide for unified reporting: a 6050Y(b) issuer will be deemed to have met its reporting obligations if the information to be reported with respect to that 6050Y(b) issuer is properly and timely reported by one or more other 6050Y(b) issuers or by a third-party information reporting contractor.¹⁹

Other Changes and Comments Affecting Reporting by Acquirers (Form 1099-LS)

In addition to the generally applicable changes already discussed, there were some minor changes made and several comments addressed that specifically relate to reporting by acquirers under section 6050Y(a) and Treas. Reg. section 1.6050Y-2.

The final regulations clarify the treatment of ancillary fees and other amounts paid in connection with the sale of a life insurance policy, generally aligning their treatment with the Form 1099-MISC reporting regime under sections 6041 and 6041A. Some commenters had requested the complete exclusion of

such ancillary amounts from the definition of an RPS payment, which Treasury declined to do because of the broad definition of “payment” in section 6050Y(d)(1)—*i.e.*, “the amount of cash and the fair market value of any consideration transferred” with respect to an RPS.²⁰ However, the final regulations do grant an exception for reporting RPS payments under section 6050Y(a) to a recipient other than the seller “if the [RPS] payment is reported by the acquirer under section 6041 or 6041A.”²¹ Additionally, the definition of RPS payment recipient was modified in the final regulations to exclude a person other than the seller who receives aggregate payments of less than \$600 with respect to the RPS;²² \$600 is the reporting threshold for payments to be reported on a Form 1099-MISC.

The preamble to the final regulations also addressed comments relating to certain transaction structures in the life settlement market. These comments included requests to exclude securities intermediaries and transitory holders of interests in a life insurance contract from the definition of an acquirer, since such holders are not the ultimate beneficial owner of the contract, as well as to exclude tertiary market transactions entirely from the definition of an RPS.²³ Treasury did not adopt the requested exemptions because the statutory definitions were broad and, in Treasury’s interpretation, do encompass these situations. However, with respect to the comments on acquirers, the final regulations clarified the allowance for unified reporting, under which an acquirer involved in a transaction having multiple acquirers, whether simultaneous or sequential, will be deemed to have met its reporting obligations if the information to be reported with respect to that acquirer is properly and timely reported by one or more other acquirers or by a third-party information reporting contractor.²⁴ From the insurance company’s perspective, it is worth noting that only a *direct* acquirer is required to furnish the RPS statement to the issuer of the contract;²⁵ however, in a series of prearranged transfers where multiple parties take legal title to the contract, it is conceivable that the issuer may receive multiple RPS statements with respect to the same overall transaction.

Other Changes and Comments Affecting Reporting by Issuers (Forms 1099-SB, 1099-R, and 1042-S)

There were also a number of clarifying changes made in the final regulations related to reporting by issuers and payers under sections 6050Y(b) and (c) and Treas. Reg. sections 1.6050Y-3 and 1.6050Y-4, in response to comments received on the proposed regulations.

With respect to the triggers for Form 1099-SB reporting, under the final regulations, in order to constitute “notice of a transfer to a foreign person,” the notice received by a 6050Y(b) issuer must include foreign indicia.²⁶ Thus, Form 1099-SB reporting is triggered if the issuer receives “any notice of a transfer of title

to, possession of, or legal ownership of a life insurance contract ... that includes foreign indicia ... unless the 6050Y(b) issuer knows that no transfer of the contract has occurred or knows that the transferee is a United States person.”²⁷

With respect to Form 1099-R reporting, the final regulations require the form to include the “gross amount of *reportable death benefits paid* to the reportable death benefits payment recipient during the taxable year,” rather than the “gross amount of *payments made* ...” in the proposed regulations.²⁸ This clarification should prevent inappropriate duplicate reporting of other types of payments made to the recipient (*e.g.*, interest paid on a delayed death claim).

Additionally, the final regulations clarify that the requirement to file a corrected Form 1099-R after rescission of an RPS is triggered by “recovering any portion of the reportable death benefits payment from the reportable death benefits payment recipient as a result of the rescission of the reportable policy sale,” rather than simply by the receipt of notice of rescission.²⁹

The final regulations also clarify the potential overlap between filing Form 1099-R pursuant to section 6050Y(c) and filing Form 1042-S pursuant to other requirements to report U.S.-source income paid to a foreign person. The final regulations remove the specific discussion of Form W-8ECI and replace it with more general references to due diligence requirements that may apply to a payor that relies on the exception relating to foreign beneficial owners.³⁰ As stated in the preamble: “As a result, the final regulations do not require reportable death benefits paid to a foreign person that must be reported on Form 1042-S to also be reported on Form 1099-R.”³¹

TRANSFER-FOR-VALUE RULE

As detailed in our earlier article, the proposed regulations address the meaning of a transfer-for-value under section 101(a)(2), the application of the Carry-Over Basis and Related-Party Transfer Exceptions, and the scope of the term “reportable policy sale” (*i.e.*, RPS). In the discussion that follows, we focus on changes to the proposed regulations with respect to these elements of the transfer-for-value rule. Our earlier article should be referenced for a discussion of aspects of the regulatory guidance on the transfer-for-value rule that were not altered.

Effective Date for Regulations Under Section 101

The final regulations under section 101 provide different effective date rules with respect to the applicability of those regulations as relevant to tax reporting under section 6050Y and with respect to the applicability of those rules for purposes of ascertaining the tax treatment of death benefits under section 101. In the former regard, for purposes of determining whether there is an RPS or payment of reportable death benefits, Treas.



Reg. section 1.101-6(b) provides that the new regulations under section 101 apply to RPSs made after Dec. 31, 2018, and to reportable death benefits paid after Dec. 31, 2018. These effective date rules mirror those otherwise applicable for purposes of the final regulations under section 6050Y.

Treas. Reg. section 1.101-6(b) goes on to state, however, that for other purposes, including for purposes of determining the portion of death benefits that are excludable from income under section 101, the new regulations under Treas. Reg. section 1.101-1(b)-(g) “apply to amounts paid by reason of the death of the insured under a life insurance contract, or interest therein, transferred after October 31, 2019.” Since the TCJA’s amendment of the transfer-for-value rules of sections 101(a)(2) and (3) is effective for transfers after Dec. 31, 2017,³² the final regulations do not apply to transfers after Dec. 31, 2017, and on or before Oct. 31, 2019. Thus, the statute without regard to the final regulations appears to govern the tax treatment under the transfer-for-value rule of those transactions, which had raised concerns among practitioners with respect to indirect acquisitions that occurred in that time period (*e.g.*, an ordinary-course-of-business acquisition of a corporation or bank that

held life insurance). Treas. Reg. 1.101-6(b) further provides, however, that pursuant to section 7805(b)(7), which authorizes Treasury to allow use of regulations prior to their effective date, a taxpayer may apply the new final regulations of Treas. Reg. section 1.101-1(b)-(g) “in their entirety, with respect to all amounts paid by reason of the death of the insured under a life insurance contract or interest therein, transferred after December 31, 2017, and on or before October 31, 2019.”

Transfers to the Insured

The final regulations include a number of changes to the proposed regulations for situations where a policy is transferred to the insured, which is relevant to the Related-Party Transfer Exception. The final regulations’ treatment differs depending on whether the policy was previously transferred in an RPS.

Where a policy previously was transferred for value but that transfer was not an RPS, the final regulations provide for a “fresh start” if the policy is gratuitously transferred back to the insured, so that the transfer-for-value rules do not apply.³³ This is illustrated by Treas. Reg. section 1.101-1(g)(2), Example 2, which involves a policy originally owned by and covering A, which is transferred for full fair market value (“FMV”) to A’s child B but then is later gratuitously transferred by B back to A. Although the first transfer from A to B was for value, it was not an RPS due to the substantial family relationship between A and B. Since the second transfer is back to A (the insured), the Related-Party Transfer Exception to the transfer-for-value rule is available and is not tainted by the prior transfer-for-value that was not an RPS.

Where a policy previously was transferred for value and that transfer was an RPS, the final regulations provide for a more limited “fresh start.” In particular, for a policy that is transferred back to the insured where there was a prior RPS of the policy, fresh start treatment applies only to the extent the insured pays FMV for the policy and does not subsequently transfer the policy for valuable consideration or in an RPS.³⁴ This is illustrated by Treas. Reg. section 1.101-1(g)(6), Example 6, which involves a policy originally owned by and covering A, which is transferred to C in an RPS for full FMV but then is later transferred by C back to A for full FMV. Due to the subsequent transfer of the policy to A (the insured) for FMV, A’s estate will be able to exclude the entire death benefit proceeds from income, even though there was a prior transfer for value that was an RPS.

If instead A had purchased the policy for less than full FMV from C, the final regulations treat the transaction as a bargain sale, *i.e.*, as in part a transfer for valuable consideration and in part gratuitous. For the portion of the policy for which FMV is paid by the insured, fresh start treatment as just described applies, but for the gratuitously transferred portion of the

policy to the insured Treas. Reg. section 1.101-1(b)(2) limits the amount of the exclusion to the sum of the proceeds attributable to the gratuitously transferred interest that would have been excludable by the transferor if the transfer had not occurred and the premiums and other amounts subsequently paid by the transferee.³⁵ This is illustrated by Treas. Reg. section 1.101-1(g)(7), Example 7, which is a new example that has been added to the regulations.

Treas. Reg. section 1.101-1(g)(8), Example 8, offers a further example involving a policy that is initially transferred back to the insured A for full FMV (as in Example 6 above), but then A transfers 50 percent of the policy to A’s child, B, and sells the other 50 percent interest to unrelated party E for FMV in an RPS. Reflecting the fresh start provided when the policy was purchased by the insured, A, for full FMV, and also the regulations’ treatment of gratuitous transfers of policies, the excludable portion of the death benefit under B’s policy is limited under Treas. Reg. section 1.101-1(b)(2)(i) to the “sum of the amount of the proceeds attributable to the gratuitously transferred interest that would have been excludable by the transferor if the transfer had not occurred and the premiums and other amounts subsequently paid by the transferee with respect to the interest.” Since the exclusion would not have been limited to A due to the fresh start, it is not limited to B, who gratuitously received the policy from A. This treatment applies regardless of whether the transfer to B is an RPS. (Here, it would not be an RPS due to the substantial family relationship between A and B.) In contrast, the transfer to E for full FMV is an RPS, and the transfer-for-value rule will limit the excludable death benefit proceeds to the consideration E paid for the policy, including subsequently paid premiums. New example Treas. Reg. section 1.101-1(g)(9), Example 9, continues Example 8 but assumes that the policy is transferred for FMV to a family partnership.

Reportable Policy Sales—in General

A number of changes were made to the regulatory discussion of the meaning of an RPS—generally discussed in Treas. Reg. section 1.101-1(c)—in response to comments. For example, the final regulations include two new exceptions to the definition of an RPS. One exception is for “[t]he acquisition of a life insurance contract by an insurance company that issues a life insurance contract in an exchange pursuant to section 1035.”³⁶ Another exception is provided for:

The acquisition of a life insurance contract by a policyholder in an exchange pursuant to section 1035, if the policyholder has a substantial family, business, or financial relationship with the insured, apart from its interest in the life insurance contract, at the time of the exchange.³⁷

The first of these exceptions was needed because, otherwise, routine section 1035 transactions not involving any transfer for value of a policy might be subjected to the reporting requirements of section 6050Y. The second exception to RPS treatment—excluding acquisitions of the new policy received by a policyholder in a section 1035 exchange in certain circumstances—is needed but seems too narrow in that it is limited by the condition that there exist a substantial family, business, or financial relationship at the time of the exchange. (We offer further commentary about this point later in this article in connection with the regulations’ definition of a “transfer of an interest in a life insurance contract.”)

In other comments submitted on the proposed regulations, Treasury was asked to exclude gratuitous transfers from the definition of an RPS. This request was not adopted. Reflecting this conclusion, Treas. Reg. section 1.101-1(b)(2)(i) refers to a transfer that “is gratuitous, including a reportable policy sale that is not for valuable consideration.” Thus, the definition of an RPS can include some transfers that are not “sales” in the ordinary sense.

Another change relating to the scope of the RPS definition pertains to indirect acquisitions of an interest in a policy. In particular, in response to comments, an exception to the RPS definition was modified to exclude indirect acquisitions of an interest in a life insurance policy if an entity such as a partnership or trust in which an ownership interest is being acquired “directly or indirectly holds the interest in the life insurance policy and acquired that interest before January 1, 2019, or acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2.”³⁸ Comments submitted on the proposed regulations also requested that an alternative provision of the indirect acquisition exception be expanded by deleting a requirement that the entity holding the direct or indirect interest in the policy have no more than 50 percent of the gross value of its assets invested in life insurance immediately before the indirect acquisition. Treasury did not adopt this request.³⁹

RPSs: Substantial Relationship Exceptions to RPS Treatment

Under the proposed regulations, a substantial family relationship was deemed to exist between a partnership, trust, or other entity if all of the beneficial owners of the entity have a substantial family relationship with the insured.⁴⁰ The final regulations expand this rule to include situations where every beneficial owner has a substantial family, business, or financial relationship with the insured.⁴¹ Thus, for example, if one beneficial owner has a substantial financial relationship with the insured and all other beneficial owners have a substantial family relationship with the insured, the substantial relationship exception to RPS

treatment will be satisfied. The final regulations also allow the IRS through the Internal Revenue Bulletin to describe situations involving a charitable organization that will be treated as a substantial financial relationship beyond those set forth in the final regulations.

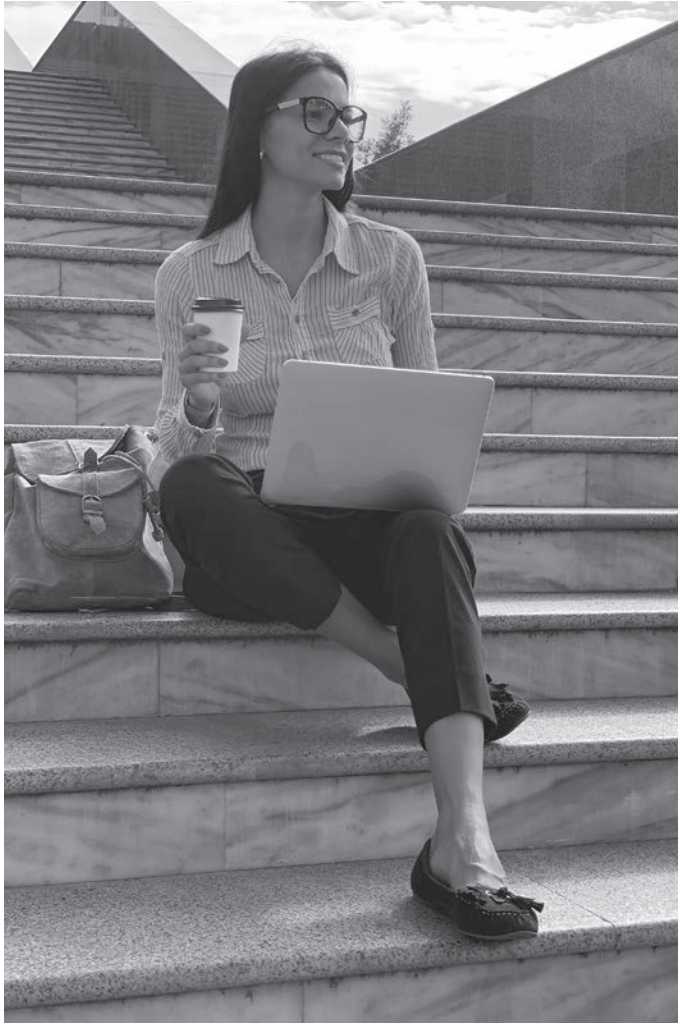
The final regulations also modify the definition of substantial financial relationship. Under the proposed regulations, one situation in which such a relationship existed is where the acquirer “maintains the life insurance contract on the life of the insured to provide funds to purchase assets or satisfy liabilities following the death of the insured.”⁴² The final regulations clarify that the policy must be maintained “to provide funds to purchase assets of or to satisfy liabilities *of the insured or the insured’s estate, heirs, legatees, or other successors in interest*, or to satisfy other liabilities *arising upon or by reason of the death of the insured*.”⁴³ In the context of bank-owned life insurance, comments had requested clarification that certain bank-owned life insurance pooling arrangements of policies were within the scope of the rule. Treasury did not adopt the requested clarification, noting that a bank in such pooling arrangements did not have a substantial financial relationship with respect to insureds under policies contributed to the pooling arrangement by other banks.

Transfers of an Interest in a Life Insurance Contract

The final regulations retain the proposed regulations’ definition of a “transfer of an interest in a life insurance contract.”⁴⁴ The final regulations thus provide that such a transfer does not include “[t]he revocable designation of a beneficiary of the policy proceeds (until the designation becomes irrevocable other than by reason of the death of the insured).”⁴⁵ Similarly, the final regulations provide that a transfer of an interest in a life insurance contract does not include “the issuance of a life insurance contract to a policyholder, other than the issuance of a policy in an exchange pursuant to section 1035.”⁴⁶

The reference to section 1035 exchanges in the definition of a “transfer of an interest in a life insurance contract” appears to indicate that a policy received by a policyholder in a section 1035 exchange would be characterized as having been transferred, even though the term “transfer” seemingly connotes that property preexisted, which was capable of being transferred. The preamble to the final regulations reflects this viewpoint.⁴⁷ For a newly issued life insurance policy, however, that policy did not exist prior to its issuance, and thus it is difficult to see how it could be transferred. In this regard, it seems that the “issuance” of a policy should be distinguishable from a “transfer” of a policy. Regarding the rationale for the treatment applied by the final regulations, the preamble to the final regulations explains:

The concern prompting the reference in § 1.101-1(e)(2) of the proposed regulations to section 1035 exchanges



related to the possibility that a policy transferred in a reportable policy sale subsequently could be exchanged for a new policy in an exchange pursuant to section 1035 and that, absent the reference in § 1.101-1(e)(2), the death benefits paid under the new policy might not be reported under section 6050Y(c).⁴⁸

The regulations seemingly could have provided for a carryover of tax attributes to prevent cleansing of attributes associated with the policy given in the exchange, such as whether that prior policy had been acquired in a transfer for value, but the treatment accorded under the final regulations appears to be broader, applying even if there has been no prior transfer for value. In such a circumstance, the tax policy underlying the transfer-for-value rule seems entirely absent, and the tax policy underlying section 1035 arguably is undermined. The exceptions to application of the transfer-for-value rule contained in section 101(a)(2)(A) and (B), and the exceptions to RPS treatment, often would ameliorate this concern, but not in all cases.

The final regulations also clarify that an “acquisition of an interest in a life insurance contract” can be of a legal or beneficial interest.⁴⁹ Treas. Reg. section 1.101-1(g)(16), Example 16, illustrates a situation in which two persons acquire an interest in a contract, one the legal title holder and the other a beneficial owner. Both the transfer of legal title to the nominee and the transfer of economic benefits to the beneficial owner are treated as RPSs.

Indirect Acquisitions of an Interest in a Life Insurance Contract

The definition of RPS includes certain direct and indirect acquisitions of interests in life insurance contracts. Comments submitted on the proposed regulations requested expansion of the exceptions to RPS treatment to encompass certain tax-free reorganizations that were not encompassed by exceptions included in the proposed regulations. This request focused on the scope of Treas. Reg. section 1.101-1(e)(3)(ii), which defines “indirect acquisitions of an interest in a life insurance contract” and excludes from the scope of this term acquisitions of an interest in a C corporation where 50 percent or less of the gross value of the assets of the C corporation consisted of life insurance contracts immediately before the indirect acquisition. The comments expressed concern that the exception did not extend to certain tax-free reorganizations where an interest in a life insurance contract is directly acquired, including where the separate corporate existence of the target terminates. Treasury did not adopt this request to extend the exception to all tax-free reorganizations.

Similar comments were offered in connection with the special rule of Treas. Reg. section 1.101-1(c)(4)(i), which provides for purposes of the RPS definition that an acquirer of an indirect interest in a policy is deemed to have a substantial financial or business relationship with the insured if the direct holder of the interest has such a relationship with the insured both before and after the acquirer acquires its interest. Comments noted that this rule could apply for certain reorganization transactions but not others, *e.g.*, where the insured’s employment terminates as a result of an acquisition or merger or where the person that previously held an indirect interest acquires a direct interest. Treasury did not adopt the request to extend the rule to these other situations, although Treasury noted that other exceptions to RPS treatment may apply depending on the facts.

REVISION REGARDING SCOPE OF SECTION 101

Prior to the effective date of Treasury Decision 9879, Treas. Reg. section 1.101-1(a)(1) provided that death benefits that were within the scope of section 101 included “[d]eath benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen’s compensation insurance contracts, endowment contracts, or accident and health insurance contracts.” The final regulations amended this provision so that it continues to apply only to

contracts issued on or before Dec. 31, 1984. Presumably, for later issued contracts, it is necessary that the contract, or portion of a contract, constitute life insurance under applicable law within the meaning of section 7702(a) and that such contract or portion of a contract otherwise satisfy the requirements of section 7702 in order for death benefits to be within the scope of section 101. The regulations do not discuss if or in what circumstances this might be the case in the context of health insurance policies.⁵⁰

CONCLUDING THOUGHTS

The Treasury and IRS are to be commended for the thoughtful manner in which they have provided guidance on the TCJA's new rules for transfers for value and related reporting. The final regulations generally were responsive and appropriate in light of comments submitted and were guided by the purpose underlying the TCJA changes. Some further changes or other guidance, however, likely will be needed on a number of points, and no doubt additional questions will arise as insurers and other affected parties implement the new rules. ■

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ENDNOTES

- 1 Except as otherwise noted, references to "section" are to sections of the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations thereunder.
- 2 See also 84 Fed. Reg. 58460 (Oct. 31, 2019).
- 3 Pub. L. No. 115-97, title I, § 13522.
- 4 See also Treas. Reg. section 1.101-1(c).
- 5 Treas. Reg. section 1.6050Y-1(b). See also 84 Fed. Reg. 58461 (Oct. 31, 2019).
- 6 See 84 Fed. Reg. 58461 (Oct. 31, 2019) and Treas. Reg. section 1.101-6(b).
- 7 In Notice 2018-41, 2018-20 I.R.B. 584, the IRS expressed its intention of allowing additional time after the date of publication of final regulations for filing returns and furnishing statements required by section 6050Y with respect to RPSs and reportable death benefits occurring after Dec. 31, 2017, and before the date final regulations are published in the Federal Register. A similar intention is reflected by Prop. Reg. section 1.6050Y-1(b).
- 8 See 84 Fed. Reg. 58475, 58477, 58461 (Oct. 31, 2019).
- 9 84 Fed. Reg. 58475-58476 (Oct. 31, 2019).

- 10 Treas. Reg. section 1.6050Y-2(a) and (d).
- 11 See Treas. Reg. section 1.6050Y-3(a). Note that this discussion implicitly assumed that the acquirer in the gratuitous transfer is a U.S. person.
- 12 Treas. Reg. section 1.101-1(c)(2)(v).
- 13 Treas. Reg. section 1.6050Y-2(f)(3).
- 14 Treas. Reg. section 1.6050Y-3(f)(3).
- 15 Treas. Reg. section 1.6050Y-1(a)(8)(i).
- 16 84 Fed. Reg. 58471 (Oct. 31, 2019).
- 17 Treas. Reg. section 1.6050Y-1(a)(8)(ii).
- 18 Treas. Reg. section 1.6050Y-1(a)(8)(iii)(B). See also 84 Fed. Reg. 58471-58472 (Oct. 31, 2019).
- 19 Treas. Reg. sections 1.6050Y-3(b) and 1.6050Y-3(d)(3).
- 20 See also Treas. Reg. section 1.6050Y-1(a)(15), clarifying in the final regulations that the "consideration" must be reducible to a money value.
- 21 Treas. Reg. section 1.6050Y-2(f)(2).
- 22 Treas. Reg. section 1.6050Y-1(a)(16)(ii).
- 23 84 Fed. Reg. 58473-58474 (Oct. 31, 2019).
- 24 Treas. Reg. sections 1.6050Y-2(b) and 1.6050Y-2(d)(3). The proposed regulations allowed unified reporting only for a series of prearranged transfers; the final regulations added simultaneous transfers of different interests in a single life insurance contract.
- 25 Treas. Reg. section 1.6050Y-2(d)(2)(i)(B).
- 26 Treas. Reg. section 1.6050Y-1(a)(10).
- 27 *Id.*
- 28 Treas. Reg. section 1.6050Y-4(a)(4) (emphasis added).
- 29 Treas. Reg. section 1.6050Y-4(d).
- 30 Treas. Reg. section 1.6050Y-4(e)(1). Note that the discussion of Form W-8ECI is retained in the provisions relating to Form 1099-SB reporting; see Treas. Reg. section 1.6050Y-3(f)(1).
- 31 84 Fed. Reg. 58477 (Oct. 31, 2019).
- 32 TCJA section 13522(c).
- 33 Treas. Reg. section 1.101-1(b)(2)(i).
- 34 Treas. Reg. section 1.101-1(b)(1)(iii)(B)(3).
- 35 Treas. Reg. section 1.101-1(b)(2)(i) and (iii).
- 36 Treas. Reg. section 1.101-1(c)(2)(iv).
- 37 Treas. Reg. section 1.101-1(c)(2)(v).
- 38 Treas. Reg. section 1.101-1(c)(2)(iii)(A).
- 39 See Treas. Reg. section 1.101-1(c)(2)(iii)(B).
- 40 Prop. Reg. section 1.101-1(d)(1).
- 41 Treas. Reg. section 1.101-1(d)(4)(iii).
- 42 Prop. Reg. section 1.101-1(d)(3)(ii).
- 43 Treas. Reg. section 1.101-1(d)(3)(ii) (emphasis added).
- 44 Treas. Reg. section 1.101-1(e)(2).
- 45 *Id.*
- 46 *Id.*
- 47 84 Fed. Reg. 58465-58466 (Oct. 31, 2019).
- 48 84 Fed. Reg. 58465 (Oct. 31, 2019).
- 49 Treas. Reg. section 1.101-1(e)(3).
- 50 The legislative history of section 7702 discusses contracts that in part are treated as life insurance and in part are treated as annuity contracts under state law. See, e.g., S. Prt. No. 98-169, vol. I, at 572 (1984).

ACLI Update

By Mandana Parsazad and Regina Rose

SENATOR WYDEN'S "PLAN TO FIX OUR BROKEN TAX CODE, ENSURE THE WEALTHY PAY THEIR FAIR SHARE, AND PROTECT SOCIAL SECURITY"

Senate Finance Committee Ranking Member Sen. Ron Wyden released a plan ("the Plan") on Sept. 12, 2019, to tax currently the assets of certain high-income or high-worth individual taxpayers on a mark-to-market basis, requiring taxes to be paid on built-in unrealized gain of most assets held by them annually. The Plan would also equalize the treatment of ordinary and capital income by eliminating the preferential rate applied to long-term capital gains.

Individuals who have more than \$1 million in income or own more than \$10 million in assets in any year are deemed high-income or high-worth and subject to a mark-to-market regime. A taxpayer must meet either the income or the asset threshold for three consecutive years to be subject to the mark-to-market taxation. Once a taxpayer is subject to the mark-to-market rules, they continue to be subject to them until they fail the threshold income or asset test for three consecutive tax years, at which point they have an option to elect out of the mark-to-market rules. The mark-to-market rules would eliminate the step up in basis that changes an asset's basis to the fair market value at the time of inheritance.

Assets of high-income or high-wealth individuals that are non-tradable will be subject to a lookback rule that would assess a tax when an asset is sold and would reduce incentives for the taxpayer to defer the sale of an asset. Possible lookback rules could include an interest charge on deferred tax, a yield-based tax designed to eliminate the benefits of deferral or a surtax based on an asset's holding period.

The Plan acknowledges the importance of retirement savings by continuing their taxation under current law. Assets held in retirement accounts [pension, 401(k), 403(b), 457 plans, IRAs (Simple, SEPs, Traditional or ROTH), HSAs, Archer MSAs, 529 plans and Coverdell accounts] continue under current law even if they belong to high-income or high-worth individuals whose other assets are marked to market. However, retirement accounts of more than \$3 million, family farms worth more than \$5 million and primary and secondary homes totaling more

than \$2 million are considered when calculating the threshold \$10 million in assets.

The Plan requests comments on "how anti-deferral accounting may interact with existing provisions of the tax code," such as "nonqualified deferred compensation" and "nonterm life insurance and annuities," and whether "changes to such provisions may be necessary to implement this proposal." While an anti-deferral regime is inherently inconsistent with risk protection products, public policy and tax policy should provide incentives for buying and maintaining important risk protection products like life insurance and annuities. We look forward to conveying this important message to Senator Wyden and his staff.

PRIORITY GUIDANCE PLAN

On Oct. 8, the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") released the 2019–2020 Priority Guidance Plan ("PGP") covering the period of July 2019 through June 2020. The PGP continues to prioritize implementation of the Tax Cuts and Jobs Act ("TCJA"), while taking into consideration the Trump Administration's goals to reduce regulatory burdens as expressed in Executive Orders 13789 and 13777. Several guidance projects of particular interest to the life insurance industry in which ACLI has been actively engaged were included in the PGP projects. The following list identifies items of interest to our industry, indicating when guidance has been issued and whether more is expected.

TCJA Implementation

- Guidance under §§ 101, 1016 and 6050Y regarding reportable policy sales of life insurance contracts. Notice 2018-41 was published May 14, 2018. Proposed regulations were published March 25, 2019.
- Guidance under § 807 regarding the determination of life insurance reserves for life insurance and annuity contracts, including guidance to implement changes under § 13517 of the TCJA.
 - Published Aug. 26, 2016, in IRB 2019-35 as Rev. Proc. 2019-34 (released Aug. 6, 2019).
- **New:** Revenue procedure providing guidance for an insurance company to obtain automatic consent to change its method of accounting to comply with § 846, as amended by § 13523 of the TCJA.
 - Published Aug. 12, 2019, in IRB 2019-33 as Rev. Proc. 2019-30 (released July 22, 2019).



- Regulations under §§ 1295, 1297 and 1298, including regulations addressing when foreign insurance income is excluded from passive income under § 1297(f).

- Published July 11, 2019, in Fed. Reg. as REG-105474-18 (NPRM).

- Final regulations under § 2010 addressing the computation of the estate tax in the event of a difference between the basic exclusion amount applicable to gifts and that applicable at the donor's date of death. Proposed regulations were published Nov. 23, 2018.

Burden Reduction

- Guidance under § 954, including regarding the use of foreign statement reserves for purposes of measuring qualified insurance income under § 954(i).
- Regulations under § 871(m), including with respect to non-delta-one transactions. Final and temporary regulations were issued Jan. 24, 2017. Notice 2018-72 (delaying the applicability date of portions of the final regulations) was published Oct. 1, 2018.
- Final regulations under Chapter 3 (§§ 1441–1446) and Chapter 4 (§§ 1471–1474), including rules addressing withholding on gross proceeds and foreign passthrough payments under Chapter 4; withholding requirements on insurance premiums under Chapter 4; and certain due diligence requirements of withholding agents under Chapter 3, including issues related to refunds and credits. Proposed regulations were published Dec. 18, 2018.

General Guidance

- Regulations under § 401(a)(9) updating life expectancy and distribution period tables for purposes of the required minimum distribution rules and addressing certain other issues under § 401(a)(9).
- **New:** Guidance on contributions to and benefits from paid family and medical leave programs.
- Regulations under § 72 on the exchange of property for an annuity contract. Proposed regulations were published Oct. 18, 2006.
- Guidance relating to the diversification requirements under § 817(h) for certain mortgage-backed securities purchased in the To-Be-Announced (TBA) market and for certain TBA contracts. Rev. Proc. 2018-54 was published Nov. 5, 2018.

The PGP also includes an appendix, which lists regularly scheduled publications. Of significance this year for the industry is the revenue procedure providing the annual update to the list of automatic changes for taxpayer changes in method of accounting, which is discussed in more detail in the next section.

IRS ISSUES REV. PROC. 2019-43 TO UPDATE PROCEDURES FOR § 807(f) RESERVE BASIS CHANGES

Late in 2018, the IRS issued Rev. Proc. 2019-10, which provided procedural requirements for post-TCJA reserve basis changes under IRC § 807(f). It did so by modifying Rev. Proc. 2018-31 to add new § 26.04 to the list of automatic changes of accounting methods.

In February of this year, ACLI worked with the IRS Insurance Branch to seek clarification of two aspects of § 26.04. In Rev. Proc. 2019-43, a number of changes were made to § 26.04.

Section 26.04 as added by Rev. Proc. 2019-10 provided that a taxpayer “may receive” audit protection for prior taxable years as provided in Rev. Proc. 2015-13 (the procedure for accounting method changes generally). The IRS indicated that the requirements of Rev. Proc. 2015-13 would need to be fully satisfied in order to provide audit protection. ACLI suggested that the language be changed to say a taxpayer “will receive” audit protection provided the requirements of Rev. Proc. 2015-13 are satisfied, and Rev. Proc. 2019-43 incorporates that change.

ACLI also discussed with the IRS the language of § 26.04 as added by Rev. Proc. 2019-10 that dealt with multiple reserve basis changes in a single taxable year. Rev. Proc. 2019-10 provided that multiple changes “for the same type of contract (life insurance, annuity, etc.)” would be considered a single change

with a single net positive or negative IRC § 481(a) adjustment. It also provided that “a change in basis of computing the reserve for each type of contract (life insurance, annuity, etc.) is considered a separate change in basis.” This language could have been construed to require much greater netting than had historically been the case for companies, and even could require netting for changes to vastly different types of life insurance and annuity contracts—*e.g.*, whole life and term insurance, or immediate annuities and deferred variable annuities. In the updated revenue procedure, the parenthetical is removed from the first quote, and the second quote is deleted entirely. It appears that the IRS intended that there be some flexibility for determining when netting should be done.

Most of the other changes to § 26.04 are relatively minor wording changes, such as clarifying that reserves include any item referred to in IRC § 807(c). However, two other changes are of note:

- A sentence is added to clarify that § 26.04 does not apply to any change to which Rev. Proc. 2019-30 or 2019-34 applies (relating to reserve changes required for 2018 tax returns by the statutory language of TCJA).
- Another sentence is added to require that termination of a company’s status as a life insurance company would, in accordance with IRC § 807(f)(2), require acceleration of any remaining § 481(a) adjustments for reserve basis changes.

PROPOSED REGULATIONS UNDER § 382(h)

On Sept. 10, proposed regulations were published regarding the items of income and deduction included in the calculation of built-in gains and losses under IRC § 382 that would affect utilization of losses by corporations that experience an ownership change. Because these proposed regulations presented issues that were of importance to the life insurance industry, ACLI filed comments on the proposed regulations.

IRC § 382 imposes a limitation on the ability of a “loss corporation” to offset its taxable income in periods subsequent to an ownership change with losses attributable to periods prior to the ownership change. On the one hand, if the loss corporation has a net unrealized built-in loss (“NUBIL”), the use of any recognized built-in loss (“RBIL”) recognized during the five-year post-change recognition period also is subject to the § 382 limitation. On the other hand, if the loss corporation has a net unrealized built-in gain (“NUBIG”), the § 382 limit for any year during the recognition period is increased by the recognized built-in gain (“RBIG”) for that year.

The IRS previously had provided, in Notice 2003-65, two methodologies for computing NUBIG/NUBIL and determining RBIG/RBIL. In general, the proposed regulations follow one of

those methodologies (the “1374 approach”), with a few significant and largely taxpayer-unfriendly modifications. ACLI’s comment letter on the proposed regulations focused on the following matters of particular importance to the life insurance industry:

- The primary intangible asset in life insurance company acquisitions generally is the value of insurance-in-force (“VIF”) that arises from long-term contractual relationships with policyholders and that does not have value independent of the contractual obligations. In computing NUBIG/NUBIL, the proposed regulations’ hypothetical sale of assets to a buyer that assumes no liabilities is impossible to apply in the valuation of VIF.
- The valuation of VIF is dependent in part on the measurement of liabilities for policy reserves. Life insurance companies are allowed a tax deduction for life insurance reserves and should use those reserves in determining the value of VIF. Tax deductible reserves should not be treated as noncontingent or contingent liabilities in the computation of NUBIG/NUBIL, and post-ownership decreases/increases in such reserves should not give rise to RBIG/RBIL.
- The proposed regulations violate the “neutrality principle” underlying the statutory provisions of § 382 by denying, except in the case of a disposition, recognition of VIF as RBIG, as it is earned during the recognition period.
- A binding contract exception should be included in the applicability dates provision of the regulations that recognizes the customary regulatory approval conditions applicable to life insurance company acquisitions.

These proposed regulations are a matter of great interest to the U.S. corporate business community as a whole, and a great many comment letters were filed prior to the end of the comment period. For this and other reasons, it is not expected that further action will be taken by the IRS with respect to the proposed regulations for many months to come. ■

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IRS Chief Counsel Advice Addresses Interest Rate Election for Life Insurance Reserves

By Brien J. Alvino and Mark S. Smith

In late September 2019, the Internal Revenue Service (IRS) released a chief counsel advice memorandum (CCA 201939003) that would limit an insurer's ability to make an election for determining the interest rate used to compute tax-deductible life insurance reserves. Although the election itself was repealed for taxable years after 2017 by the Tax Cuts and Jobs Act of 2017,¹ a number of companies made the election for purposes of determining their reserves as of Dec. 31, 2017.

BACKGROUND

Section 807 of the Internal Revenue Code governs the computation of tax-deductible life insurance reserves. Before the Tax Cuts and Jobs Act of 2017, section 807 required an insurer to compute a federally prescribed reserve, based on a tax reserve method and prescribed interest rate and mortality tables. The federally prescribed reserve was compared to a cap (the statutory reserves with regard to the contract) and a floor (the contract's net surrender value) to determine what portion was tax-deductible.

The interest rate used to compute the federally prescribed reserve was the higher of the Applicable Federal Interest Rate (AFR), a defined term under the Internal Revenue Code, or the Prevailing State Assumed Interest Rate (PSAIR), the highest rate permitted to be used under the laws of 26 states, determined at the time the contract was issued. In recent years, low interest rates resulted in a low AFR, such that companies were required to use the PSAIR instead. For contracts issued in earlier years (generally, 1988 through 2004), however, the AFR often dominated.

Under section 807(d)(4), a company could elect to redetermine the AFR every five years for contracts issued in each year for purposes of the comparison. As a result, if the AFR increased in the future, life insurance reserves could decrease for existing business; if the AFR decreased, life insurance reserves could increase (provided the change was at least 50 basis points and the redetermined AFR was greater than the PSAIR for the year the contract was issued). The



purpose of the election was “to take account of the fluctuations in market rates of return that companies experience with respect to life insurance contracts of long duration.”² An election made under the provision resulted in a more current economic measure of an insurer's obligations under a contract, because the interest rate used was more current and resulted in a closer match to current market earnings on investment assets than to historic earnings on investment assets at the time the contract was issued.

The election applied to all contracts issued during the calendar year for which the election was made, or during any subsequent calendar year. A company that made the election could revoke that election only with IRS consent. Although the IRS never published guidance on the mechanics of making the election, it released two private letter rulings in 2016 granting permission for the particular companies involved to revoke previously made elections. The revocations applied only with regard to contracts for which no interest rate redetermination had been reached (that is, contracts issued less than five years before the year of revocation).³

THE CCA

In the CCA, the insurance branch of the IRS Office of Chief Counsel provided legal advice to the IRS Large Business & International (LB&I) division on a company that attempted to make the election on an original 2017 return and amended returns for three earlier years. The company intended the election to make the election for all contracts issued after 1987, the year in which Congress enacted the election, or at least to four of the five quinquennial bands associated with the election.⁴ The difference between the Dec. 31, 2017, reserve computed with the election and the reserve computed without the election would have been reported in 2017.⁵

The CCA concludes that (1) an election under the provision cannot be made on an amended return, and (2) the election on the company's original 2017 return applied only with regard to contracts issued in 2012. Because the PSAIR exceeded the AFR in 2012, the election as allowed by the CCA would have no effect on the company's Dec. 31, 2017, reserves.

Because there is no published guidance on making the election, the analysis in the CCA depends entirely on a generally applicable

doctrine called the “Doctrine of Election,” which has been developed by the courts. Under that doctrine, a taxpayer is bound to an initial choice on a tax return between two or more inconsistent alternatives.⁶ The doctrine consists of two elements: (1) a free choice between two or more alternatives, and (2) an overt act communicating the choice to the IRS. In the case of the section 807(d)(4) CCA, the choice was between computing reserves based on the AFR in effect when a contract was issued and computing reserves based on the AFR redetermined every five years after the contract was issued. The CCA’s analysis begins by asserting that, once five years had passed from the date a contract was issued, it was too late to make the election with regard to that contract because a company had overtly communicated to the IRS its choice instead to apply the AFR as of the contract issuance date.

The CCA discusses the rationale for the Doctrine of Election, as well as reasons why that rationale applied in the case of section 807(d)(4). In particular, the CCA asserts that

- allowing the election after the fifth-year return deadline would invite accounting distortions, resulting in a loss of revenues (due to a decrease in tax rates after 2017);
- allowing the election would lead to disparate treatment of similarly situated life insurance companies;
- allowing the election would create undue administrative inconvenience for the IRS; and
- allowing the election would invite a flood of amended returns, increasing the IRS’s administrative burden and requiring a recalculation of prior years’ tax liabilities.

The CCA does not address potential counterarguments to these rationales. Ordinarily, a taxpayer that is the subject of a CCA does not participate in its development.

Although the CCA does not cite authorities specific to section 807(d), it does discuss Rev. Rul. 94-74,⁷ which governs changes in basis for computing reserves. Under Rev. Rul. 94-74, and section 807(f) as in effect in 2017, a change in basis applied to all previously issued contracts could be made on an amended return and entailed a catch-up adjustment to account for the difference between reserves computed under the old and new basis. According to the CCA, Rev. Rul. 94-74 was not relevant to the analysis because the Doctrine of Election applies only to taxpayers and because Rev. Rul. 94-74 applies only to permissible changes in basis.

WHAT COMES NEXT?

A CCA may not be used or cited as precedent,⁸ is not accorded deference by courts, and is not binding on Appeals. Rather, it is an internal communication between the IRS Office of Chief Counsel (in this case, the National Office insurance branch) and a field office in connection with the examination of a single case.

Importantly, a CCA provides a strong indication of how the IRS likely will approach the issue in the next case in examination. A CCA also provides an opportunity for companies and advisors to weigh the strength of the IRS’s arguments.

Even before the CCA’s release, opinions on the election varied among companies and among advisors. Among companies understood to have made the election, some did so by amended return (as in the CCA), while others did so by an original return for 2017. The CCA may be viewed differently by different companies and by different advisors.

The last year for which the election is relevant is 2017. The development of the issue therefore will be limited to prior years and will depend on the course of multiple examinations, multiple cases in Appeals and possibly litigation. Some of these developments will be publicly known, but most will not be disclosed. Those developments that become public likely will be discussed in future issues of *TAXING TIMES*, although the relevance to future years will be limited. ■

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ENDNOTES

- 1 More precisely, “An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018,” Pub. L. No. 115-97, enacted Dec. 22, 2017. For additional discussion concerning changes made by the Tax Cuts and Jobs Act, see generally James W. Kress, Surjya Mitra, and Mark S. Smith, “Overview of the Tax Cuts and Jobs Act: Major Changes in the Taxation of Life Insurers,” *TAXING TIMES* Vol. 14, Issue 2 (June 2018), <https://www.soa.org/globalassets/assets/library/newsletters/taxing-times/2018/june/tax-2018-vol-14-iss2.pdf> (accessed Dec. 18, 2019).
- 2 H.R. Rep. No. 100-495, at 979 (Conference Report), 1987-3 C.B. vol. 2, 979.
- 3 PLR 201645010 (Aug. 5, 2016); PLR 201640008 (July 1, 2016).
- 4 As a practical matter, the election would have affected only contracts issued before 2005, because the PSAIR has exceeded the AFR for more recent years.
- 5 As in effect for 2017, section 807(d)(4)(A)(IV) of the Internal Revenue Code provided that the 10-year spread rule of section 807(f) did not apply to an adjustment required by reason of the election.
- 6 *Pac. Nat’l Co. v. Welch*, 304 U.S. 191, 194-95 (1938).
- 7 1994-2 C.B. 157.
- 8 As stated in CCA 201939003 (June 27, 2019), this advice may not be used or cited as precedent.



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