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# Small Talk

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# Tax Update

*Small Talk* has included regulatory updates in most issues of our newsletter over the last several years but has been virtually silent on tax-related topics. We're turning that around and giving tax a voice in this issue. The following three articles in this "Tax Update" discuss general tax issues that should be of interest to those associated with smaller insurance companies. I hope you find them relevant and informative.

— Robert Hrischenko

## IRS Issues Guidance Regarding Section 7702 Qualification for Contracts Maturing After Age 100

By Brian G. King

The adoption of the 2001 Commissioners' Standard Ordinary Mortality Tables (the 2001 CSO Tables) in 2004 placed a spotlight on the tax qualification requirements for life insurance contracts that mature after age 100. Unlike prior CSO tables, the 2001 CSO Tables have a terminal age of 121, facilitating the development of life insurance contracts that mature beyond age 100. These contract designs raise some fundamental questions regarding how such contracts should be administered under Internal Revenue Code section 7702 or 7702A requirements.[1] Many of these questions are linked to the computational rules of section 7702(e)(1) which place limitations on the future benefits that can be incorporated into the section 7702 or 7702A test premiums, with particular focus on section 7702(e)(1)(B), which deems the contract to mature between the date the insured attains age 95 and the date the insured attains age 100.

In 2006, the Taxation Section of the Society of Actuaries created a task force (the SOA Task Force) to address issues relating to life insurance contracts that extend coverage beyond age 100. The SOA Task Force published its recommendations in the May 2006 issue of *TAXING TIMES* titled "2001 CSO Implementation Under IRC Sections 7702 and 7702A," which set forth a recommended methodology for applying sections 7702 and 7702A that would be "actuarially acceptable" in the case of life insurance contracts that do not provide for an actual maturity date before the insured attains age 100.

Earlier this year, the IRS responded to the industry's request for guidance on this matter, issuing Notice 2009-47[2], proposing a safe harbor addressing the application of sections 7702 and 7702A for life insurance contracts that mature after the insured attains age 100. The Notice acknowledges and draws upon the recommendations put forth by the SOA Task Force. Provided a life insurance contract satisfies ***all*** of the requirements of the safe harbor, refered to in Notice 2009-47 as the "Age 100 Testing Methodologies", the IRS "would not challenge the qualification of a contract as a life insurance

> "The Notice acknowledges and draws upon the recommendations put forth by the SOA Task Force."

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contract under § 7702, or assert that a contract is a MEC under § 7702A."

## "The Age 100 Testing Methodologies"

**Requirement 1:** All determinations under sections 7702 and 7702A (other than the cash value corridor of section 7702(d)) would assume that the contract will mature by the date the insured attains age 100, notwithstanding a later contractual maturity date (such as by reason of using the 2001 CSO Tables).

**Requirement 2:** The net single premium determined for purposes of the cash value accumulation test under section 7702(b), and the necessary premiums determined for purposes of section 7702A(c)(3)(B)(i), would assume an endowment on the date the insured attains age 100.

**Requirement 3:** The guideline level premium determined under section 7702(c)(4) would assume premium payments through the date the insured attains age 99.

**Requirement 4:** Under section 7702(c)(2)(B), the sum of the guideline level premiums would increase through a date no earlier than the date the insured attains age 95 and no later than the date the insured attains age 99. Thereafter, premium payments would be allowed and would be tested against this limit, but the sum of the guideline level premiums would not change.

**Requirement 5:** In the case of a contract issued or materially changed within fewer than seven years of the insured's attaining age 100, the net level premium under section 7702A(b) would 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.

**Requirement 6:** If the net level premium under section 7702A(b) is computed over a period of less than seven years by reason of an issuance or material change within fewer than seven years of the insured's attaining age 100, the sum of the net level premiums would increase through attained age 100. Thereafter, the sum of the net level premiums would not increase, but premium payments would be allowed and would be tested against this limit for the remainder of the seven-year period.

**Requirement 7:** The rules of section 7702A(c)(2) and (6) concerning reductions in benefits within the first seven contract years would apply whether or not a contract is issued or materially changed fewer than seven years before the date the insured attains age 100.

**Requirement 8:** A change in benefits under (or in other terms of) a life insurance contract that occurs on or after the date the insured attains age 100 would not be treated as a material change for purposes of section 7702A(c)(3) or as an adjustment event for purposes of section 7702(f)(7).

**Requirement 9:** Notwithstanding the above described methodologies, a contract that remains in force would additionally be required to provide at all times a death benefit equal to or greater than 105 percent of the cash value.

"Requiring a minimum death benefit that is at least 105 percent of the cash surrender value after age 100 seems inconsistent with the statutory requirements before age 100."

## Concluding Thoughts

As noted above, the "Age 100 Testing Methodologies" generally follow the recommendations of the SOA Task Force, with one material exception—the requirement that a contract provide a death benefit that is at least 105 percent of the cash value. As expected, the minimum death benefit requirement has not been well received by the life insurance industry and is perceived as being inconsistent with the minimum death benefit requirement currently required by section 7702, which generally grades to 100 percent of the cash surrender value for contracts that mature between ages 95 and 100. Requiring a minimum death benefit that is at least 105 percent of the cash surrender value after age 100 seems inconsistent with the statutory requirements before age 100. A number of industry trade groups are expected to respond to the IRS with comments on the proposed safe harbor, with particular focus on this requirement. Comments are requested to be filed with the IRS by Oct. 13, 2009.

# IRS Issues Guidance on Tax Treatment of Life Settlement Transactions

By Brian G. King

The growth of the life settlement market continues to create opportunities for owners of life insurance contracts willing to sell their contract to investors for amounts in excess of the contract's cash surrender value. A number of questions exist regarding the tax consequences of this type of transaction for both sellers and buyers of life insurance contracts, as current tax law does not anticipate the development of a secondary market for the sale of life insurance contracts. On May 1, 2009, the Internal Revenue Service (IRS) answered a number of these questions by issuing a pair of revenue rulings addressing the tax treatment of certain types of life settlement transactions. The first of these two rulings (Revenue Ruling 2009-13) addresses the tax consequences when an original individual owner surrenders or sells his life insurance contract. The later ruling (Revenue Ruling 2009-14) provides guidance to investors who purchase life insurance contracts.

## Guidance for Individual Policyholders

Revenue Ruling 2009-13 addresses three situations in which an individual enters into a life insurance contract under which the individual is the insured and a family member is the named beneficiary. The first situation addresses the surrender of the life insurance contract for its cash surrender value, while in the second and third situations, the individual sells the life insurance contract to an unrelated person. In each of these three situations, the ruling determines the amount of income that the individual must recognize upon the surrender or sale of the life insurance contract, and in addition, the characterization of the income (capital gain or ordinary income).

In Revenue Ruling 2009-13, the IRS concludes that the tax rules for determining income differ depending on whether an individual owner surrenders or sells a life insurance contract, even though there is no substantive difference between these two transactions from the perspective of the policy owner. Revenue Ruling 2009-13 confirms that in the case of a surrender, the individual must recognize income to the extent the amount received exceeds the ***investment in the contract***, as determined by section 72(e) of the Internal Revenue Code.[3] Section 72(e) generally defines investment in the contract to be the premiums paid, without any reduction for cost of insurance or other charges applicable to the contract. The ruling concludes that income is the excess of the cash surrender value over premiums paid, and further specifies that this income is characterized as ordinary income, and not capital gains.

In the case of a sale of a life insurance contract to an unrelated person, the individual recognizes income to the extent the amount realized in the sale exceeds the individual's ***basis in the contract***. In determining the amount of income, the ruling determines that the individual's basis in the contract is the individual's investment in the contract, reduced by the already incurred costs of providing life insurance on the insured's life (*i.e.*, the cost of insurance). The ruling then concludes that the amount realized, up to the contract's inside buildup (*i.e.*, the amount of income that would have been realized had the individual surrendered the contract) is ordinary income, and the amount of income realized that exceeds the inside buildup is capital gain. A consequence of the position taken by the IRS on this issue requires policyholders who sell their policies to third parties to obtain "cost of insurance" information from the life insurance company in order to fill out their tax returns—information that may not be regularly provided to policyholders. A further complicating factor likely to arise is in the determination of "cost of insurance." The identification of the cost of insurance for a life insurance contract is not always a straightforward calculation, particularly in the case of a whole life contract or other forms of life insurance that do not explicitly define the cost of insurance.

Revenue Ruling 2009-13 indicates that the IRS position on excluding cost of insurance from basis, and treating a portion of the gain on sale as ordinary income, will not be applied to sales occurring before Aug. 26, 2009.

## Guidance for Life Settlement Investors

In conjunction with Revenue Ruling 2009-13, the IRS also issued Revenue Ruling 2009-14, which addresses the tax treatment of transactions involving the purchase and sale of life insurance policies by investors. Revenue Ruling 2009-14 presents three situations where a U.S. citizen purchases a life insurance contract and then receives death benefits or sale proceeds from the life insurance.

Revenue Ruling 2009-14 confirms that when an investor buys a policy as an investment and holds it until the death of the insured, the investor is taxable on an amount equal to the death benefit received, less the cost to acquire the policy and the amount of premium subsequently paid. This conclusion reflects a straightforward application of the section 101(a)(2) transfer for value rules. The ruling concludes that the taxable portion of the death benefit is ordinary income, and not capital gain. If the investor is a foreign corporation not engaged in a

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trade of business within the United States, the taxable portion of the death benefit would be subject to U.S. tax as the income is "fixed or determinable annual or periodical income" and should be regarded as U.S. source income generally subject to a 30 percent withholding tax.

Revenue Ruling 2009-14 also addresses an investor's resale of a life settlement policy prior to the death of the insured. The ruling concludes that an investors tax basis in the life insurance contract includes the acquisition costs and the full amount of premiums paid by the investor, without reduction for cost of insurance (as was required by Revenue Ruling 2009-13 in the case of the sale of a life insurance contract by the original owner). The income received on the resale (*i.e.*, the sale proceeds less the investor's tax basis) would be a capital gain.

## Concluding Thoughts

Revenue Rulings 2009-13 and 2009-14 address many of the income tax consequences of transactions in the life settlement market, including the determination of basis, the amount of income to be recognized and the character of that income. As a result, policyholders involved in the sale of their life insurance contract may be looking to their insurance company to provide the necessary cost of insurance information needed to complete their tax returns. In addition, insurance companies may also be subject to additional withholding and reporting requirements on the payment of death benefits to investors. While these rulings provide some welcome guidance, they highlight the importance for insurance companies to monitor life settlement transactions within their in force, as well as the evolving tax consequences of these transactions.

# Update on U.S. Statutory Deferred Taxes

By Edward L. Robbins

Currently in the United States, the accounting bases utilized by the insurance industry include regulatory (Statutory) accounting and accounting under Generally Accepted Accounting Principles (GAAP). Deferred taxes constitute an important element of both accounting systems. The primary purpose of the deferred tax concept is to account appropriately in the balance sheet for future taxable income whose incidence is expected to differ from future book income. A deferred tax asset (DTA) is established for the tax already paid or accrued on income to be recognized in a latter accounting period. DTAs therefore represent amounts that an insurance company may be able to use to offset future tax liabilities if the insurer ultimately will have other future taxable income. Similarly, a deferred tax liability (DTL) is set up to represent that tax liability arising when book income is taxable in a latter accounting period.

Insurance company DTAs and DTLs can arise from many different sources, including insurance contracts, invested assets and business combinations. Basis differences between statutory and tax reserves are one of the major drivers of insurance company DTAs in the United States. This difference is commonly referred to as a "temporary difference" as the effects tend to reverse themselves over time. Typically, a DTA is established when policies are issued, as taxable income generally exceeds statutory income due to the higher statutory reserve or section 848 (Tax DAC) requirements. The future reversal of this temporary difference occurs as reserves draw down over time, creating future tax deductions relative to future pre-tax statutory income, thus reducing the DTA balance.

Current Statutory accounting rules significantly restrict the ability to fully recognize DTAs. Users of financial statements are better served if the accounting rules and requirements for determining the admitted portion of the deferred tax balance is determined using rules that are sufficiently close to the theoretically proper approach. Thus, the net admitted DTA, if appropriately calculated, should represent the future economic tax benefit (or tax cost) resulting from temporary differences in the reporting of statutory versus taxable income.

## History of Deferred Tax Treatment in the United States

U.S. GAAP has long recognized the importance of proper deferred tax treatment. Under U.S. Statutory accounting rules for tax years prior to year-end 2001, however, only current tax expense was considered. Beginning at year-end 2001, under codification of U.S. Statutory Accounting Principles,[4] statutory deferred taxes were introduced. In general, the statutory rules for deferred tax treatment were made relatively explicit, ostensibly to provide for the possible non-availability of other future taxable income to offset the future tax deductions represented by the DTAs. However, the limitation on the

admissibility of DTAs (*i.e.*, the amount recognized on the Statutory balance sheet) could only be expressed as "severe," generally far more than necessary to cover such nonavailability. The severity of those constraints was possibly due in part to the regulators' discomfort with the newness of the concept in 2001 and in part due to their perception that they were dealing with a nonliquid asset. The resulting net admitted DTAs tend to omit the predominant portion of future tax deductions arising from temporary differences resulting from reserves.

The current statutory rules for calculation of DTAs and DTLs are set out in SSAP No.10.[5] The SSAP No. 10 guidance is summarized in a paper currently on the Society of Actuaries Taxation Section Web page, entitled "Deferred Tax Treatment of U.S. Statutory Policyholder Liabilities in Life Insurance Companies" (the Taxation Section paper). For most life insurers, SSAP No. 10 limits the statutory admissibility of DTAs to the lesser of:

1) 10 percent of prior quarter end capital and surplus; or,

2) The marginal tax rate on only those temporary differences that are expected to reverse within 12 months of the statement date.

Considering that reserve differences and Code section 848 acquisition costs (another major contributor to the DTA) tend to reverse over a 10 to 40 year time span, and considering the availability of three-year net operating loss carry-backs and 15-year net operating loss carry-forwards, the 12-month limitation is indeed a severe constraint.

Shortly before year-end 2008, the American Council of Life Insurers (ACLI) requested that the statutory rules covering admissible DTAs be revised toward what many in the industry would consider to be a more appropriate basis.[6] The ACLI brought its proposal to the NAIC, and the NAIC formed a Capital and Surplus Relief Working Group (the NAIC Working Group) to review the ACLI's request. The NAIC ultimately rejected the ACLI's request for liberalizing the existing rules for year-end 2008 despite the recommendation of the NAIC Working Group. An account of those negotiations was written by W. Elwell and published in the May, 2009 issue of *TAXING TIMES*.[7]

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Shortly after those 2008 year-end NAIC negotiations, several states issued "Permitted Practices" to their domiciled companies, enabling them to increase their admissible DTA balances as of year-end 2008, as had been recommended by the NAIC Working Group in December. The NAIC Statutory Accounting Principles Working Group is continuing to review the issues surrounding the DTA concepts, possibly considering a change for year-end 2009 reporting.

### Theoretical Underpinning

The Taxation Section paper, referred to above, discusses the theoretical basis of deferred taxes and illustrates that, under reasonable conditions and under a fully admissible DTA, post-tax statutory book profits are equal to pre-tax statutory book profits multiplied by the complement of the marginal tax rate (MTR).

The theoretical basis is approximately described below in a simplistic example, avoiding many of the complicating situations that typically arise in practice. The following simplifying assumptions have been made:

- Level future MTR (35 percent, the U.S. MTR for most large insurers);

- The insurer remains "fully taxable" throughout the future time horizon, sufficiently so to accommodate the future tax deductions embedded in the DTA.

- The change in DTA is presumed to be included in the "Summary of Operations," as opposed to current statutory accounting treatment, wherein changes in DTAs and DTLs are a direct adjustment to capital and surplus.

- Other items, such as the Tax DAC"(pursuant to U.S. Internal Revenue Code Section 848) are ignored.

- The DTA is fully admissible, *i.e.*, not subject to the SSAP No. 10 constraints.

As a starting point, assume statutory reserves for a block of business are $1,000 and tax reserves are 90 percent of statutory reserves, or $900. In our simplified model, the

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resulting DTA would be 35 percent * ($1,000 – $900), or $35. Future taxable income from the tax reserve release will be $100 less than the statutory book income from the statutory reserve release, resulting in a tax benefit of $35. The DTA is thus equal to the future reduction in taxes to be paid as a result of the runoff of this statutory-to-tax temporary difference.

To illustrate the appropriateness of the above DTA, *i.e.*, that the appropriate DTA results in post-tax statutory earnings equal to (pre-tax statutory earnings)*(1- MTR), assume that the block were to terminate in the following year and incur claims of $800. In such case the statutory earnings with respect to the policyholder liability would be as follows (algebraic signs reflect the effect on capital and surplus):

| | | |
|---|---|---|
| Statutory Reserve Release | $1,000 (+) | |
| Death Claims | 800 (-) | |
| Pre-tax Statutory Earnings | $ 200 (+) | (1) |
| Tax: | | |
| 35% of Claims | $ 280 (+) | |
| 35% of $900 Tax Reserve Release | 315 (-) | |
| Release of DTA | 35 (-) | |
| Post-tax Statutory Earnings | $ 130 | (2) |
| Ratio of (2) to (1), above | 65% | |

By reflecting the change in the DTA in the income statement, this example provides the theoretically correct result whereby the ratio of post-tax statutory book profits to pre-tax statutory book profits equals the complement of the marginal tax rate (MTR).

The Taxation Section paper also discusses the theoretical effects of discounting in the determination of DTAs, recognizing that a $100 tax benefit in year 20 years does not have the same value today as $100 tax benefit in year two. Suffice it to say that when discounting of deferred tax costs and benefits are factored into the analysis, the above ratio will still hold, although the equivalent calculations are more complex.

It is hoped that, with the continuing negotiations between the industry and the NAIC, an agreement can be arrived at that constitutes a reasonable compromise between proper theory and practicality.

FOOTNOTES:

[1] Except as otherwise indicated, references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").
[2] 2009-24 I.R.B. 1083.
[3] Except as otherwise indicated, references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").
[4] Codification was pursuant to the "Accounting Principles and Procedures Manual," an annual publication of the NAIC. The primary objectives of the codification project were more complete disclosures, more comparable financial statements for insurers, and a comprehensive guide for use by insurance companies and insurance departments.
[5] Statement of Statutory Accounting Principles No. 10, *Income Taxes*, Accounting Practices and Procedures Manual, National Association of Insurance Commissioners (NAIC), 2008.
[6] Increase in the limits from the above-cited 10 percent of capital to 15 percent, and extension of the "years limit" on reversals from one year to three years.
[7] *TAXING TIMES* is the newsletter of the Taxation Section of the Society of Actuaries.

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