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X-Rated Reserves: AXXX and XXX

by Christian DesRochers

The label "XXX" has a certain connotation to most of the world, but for the life insurance industry, it refers to the statutory reserve standards for term insurance and secondary-guarantee universal life (SGUL). For at least a decade, the reserve standards articulated in *The Valuation of Life Insurance Policies Model Regulation* (Regulation XXX) and more recently, Actuarial Guideline 38, *The Application of the Valuation of Life Insurance Policies Model Regulation* (AXXX) have been the subject of controversy within the life insurance industry. The discussions have been spirited, and at times heated, with strong feeling on both sides of the issue. While most debates on actuarial issues would be rated "G," the XXX issues have been rated "X," with no one under 17 admitted. What some people see as innovative product design, others see as attempts to sidestep the "spirit" of the regulation. What some see as appropriate levels of statutory reserves, other see as excessive, unnecessarily raising the cost to buyers of term insurance and SGUL products. Arguably, the issues surrounding XXX and AXXX have been a driving force in the development of principles-based reserves (PBR). The story of XXX and AXXX also has federal income tax aspects, which is the subject of this article.

Background

The National Association of Insurance Commissioners (NAIC) promulgated the original Regulation XXX in 1995, but it was adopted only by New York as Regulation 147, *Valuation of Life Insurance Reserves*. A revised XXX, *The Valuation of Life Insurance Policies Model Regulation,* was adopted by the NAIC in March 1999, effective Jan. 1, 2000.[1] Although the Model Regulation was formally enacted by approximately only 40 states, it is a part of codification (as Regulation 830), so it is effectively the reserve standard in all states. The Actuarial Standards Board (ASB) published ASOP 40, *Compliance with the NAIC Valuation of Life Insurance Policies Model Regulation with Respect to Deficiency Reserve Mortality* in December 2000. The NAIC Life and Health Actuarial Task Force (LHATF) approved Actuarial Guideline 38 (AXXX) *Application of the Valuation of Life Insurance Policies Model Regulation* in 2002 to be effective on Jan. 1, 2003. Together the Model Regulation, ASOP and AG 38 provide the framework for statutory reserves for term insurance and SGUL.[2]

Statutory Reserve Methods for Term Policies

The Standard Valuation Law defines reserves prospectively, as the present value of future benefits less the present value of future valuation net premiums. As a corollary, at issue the present value of future valuation net premiums is equal to the present value of future benefits. Valuation net premiums generally follow the pattern of gross premiums; that is, the valuation net premium is determined as a uniform percentage of the gross premium.[3]

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[1] The "original" XXX had 15-year select factors that could be used to adjust the valuation mortality table, while the "revised" 1999 XXX used 20-year select factors.

[2] The American Academy of Actuaries (Academy) also published an XXX Practice Note in February 2001, which was updated in December 2006.

[3] For purposes of simplicity, the reserve discussion is ignoring the effect of a modified valuation method, where a different first year valuation premium is used. Under XXX, a CRVM allowance is permitted only in the first segment.

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FROM THE EDITOR

BRIAN G. KING

Hello readers! Welcome back to another year and another issue of *Taxing Times*. It is hard to believe that this issue marks the beginning of our fourth year of publication. It seems like just yesterday that we were in the planning stages of this newsletter. During that planning process, we made a commitment to produce an informative newsletter, to promote the exchange of tax knowledge to our membership and to add enhancements that would further our objectives. With these commitments in mind, we are pleased to announce a new feature to our newsletter. Beginning with this first issue of Volume 4, we will be including an American Council of Life Insurers (ACLI) Update Column.

Our readers may recall that in our last issue of *Taxing Times*, the Tidbit column included an ACLI Update on an Actuarial Guideline on Reserves for Variable Annuities (AG VACARVM). The ACLI is involved in numerous tax issues impacting the life insurance industry. Their active involvement in these issues through work with multi-company task forces, the Treasury Department (Treasury), the Internal Revenue Service (IRS) and the National Association of Insurance Commissioners (NAIC) provides them with a multi-dimensional view of the issues at hand. They are poised to offer informative and timely updates on these issues. With that in mind, the new ACLI Update column will provide such timely and informative updates on the tax issues impacting our industry.

On behalf of the Taxation Section Council, I would like to thank Ann Cammack, former ACLI senior vice president, whose dedication and vision opened up the door and established this relationship between the ACLI and *Taxing Times*. Without Ann, and without this relationship, this update column would not have been possible. We all wish Ann the very best in her new position as vice president & senior council at MassMutual Financial Group.

I would also like to take this opportunity to congratulate Ann's replacement at the ACLI, Walter Welsh. Coming from the Hartford Life, Walter has been named as ACLI executive vice president of taxes and retirement services. The Taxation Section owes Walter thanks for his willingness to continue support for the relationship between the ACLI and our section. His commitment of ACLI resources to provide these updates to our newsletter is greatly appreciated.

Finally, one more person who needs mention and a big thank you is Bill Elwell, senior tax council at the ACLI. Bill authored the ACLI Tidbit article mentioned above that appeared in our last issue. In addition, he has agreed to author the initial ACLI Update Column which appears in this issue. Without his assistance, this Update Column would not have been possible.

Again, the Taxation Section's mission is to promote and foster the exchange of insurance tax knowledge among our membership. Our section newsletter does a great job towards achieving this goal. The addition of this new column reinforces and furthers these efforts. Enjoy the ACLI Update Column and the rest of the issue!

Brian G. King, FSA, MAAA, is a vice president with Aon Consulting in Avon, Conn. and may be reached at *brian_king@aon.com*.

Note from the Editor

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

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

—Brian G. King

October 4, 2007

Dear Mr. King,

I enjoyed reading "Is Homogeneity Required to Qualify as Insurance?" in the September 2007 edition of *Taxing Times*. I am writing to elaborate on the impact of covering a diverse range of alternative risks on the risk-distribution requirement of the definition of insurance.

An insurer decreases the variance (spread) of risk per dollar of premium set aside to cover its obligations by distributing an increasingly larger number of separate risks. This decreases the upper limit of reserves needed for an insurer to be sufficiently confident that its obligations will be covered because the risk of loss (per dollar of premium) is more predicable as a result of the statistical "law of large numbers." Along the same lines, by diversifying the types of risks covered, an adequately funded insurer can be more confident that it can cover its incurred losses.

The authors of the article indicate that covering separate types of risks can enhance risk distribution, stating, "a combination of an adequate pool of one type of risk (*e.g.,* workers' compensation) with an adequate pool of another risk (*e.g.,* property) can provide more risk distribution than a larger, separate pool of either type of risk alone." *Id.* at 22. The Tax Court's analysis in *Utah Medical Ins. Assoc. v Commissioner*, 76 T.C.M. 1100 (1998), arguably supports the authors' view.

Utah Medical was an interinsurer (reciprocal) that primarily provided medical malpractice coverage. It was created by a group of physicians in Utah in response to the increase in premium rates for medical malpractice insurance by the commercial insurer that provided the coverage for them.

A property and casualty insurer, such as Utah Medical, can deduct an increase in its reserves for unpaid losses in a given taxable year. *See* Internal Revenue Code sections 832(b)(3) and 832(b)(5)(A)(ii). A reserve for an insurer's unpaid losses "is an estimate, made at the close of a taxable year, of the insurer's liability for claims that it will be required to pay in future years." 76 T.C.M. at 1107. Treasury Regulation section 1.832-4(b) provides that unpaid losses "must be stated in amounts which, based upon the facts in each case and the company's experience with similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay."

The Commissioner argued that Utah Medical's reserves for unpaid loss were too large. The Tax Court concluded, however, that Utah Medical's estimates of unpaid losses were "fair and reasonable." The court stated,

[Utah Medical] could not offset reserve deficits with reserve surpluses in another line of insurance because it wrote a single, relatively volatile line of business in a limited market. The inability to offset deficits with surpluses makes petitioner's business more risky and reasonably led petitioner to establish higher reserves.

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Id. at 1108.

That is, a more diversified set of covered risks would provide for a more precise range of estimates of "fair and reasonable unpaid loss reserves" (per premium dollar) because the law of large numbers would result in a more precise range of expected losses (per premium dollar).

Utah Medical did not involve whether the underlying medical malpractice coverage qualified as insurance contracts for tax purposes. The Tax Court's reasoning, however, can be applied in cases involving the definition of insurance because the court, in effect, concluded that by providing more than one type of coverage an insurer can enhance its risk distribution by diversifying its alternative risks.

Sincerely yours,

Emanuel Burstein

Taxing Times welcomes feedback from our readers. Share your comments and viewpoints with us by sending them to the editor, Brian King, at *brian_king@aon.com.*

The Biennial Product Tax Seminar is Coming!

Washington, D.C.
Fall 2008

As planning for this seminar gets underway, we welcome feedback and suggestions for course content. Some of the topics covered in the past include 7702, 7702A, Annuities, Long-Term Care and Combination Products. What product tax issues interest you? Contact Brian G. King at *brian_king@aon.com* with your ideas!

FROM THE CHAIR

KORY J. OLSEN

The SOA Taxation Section has had great momentum over the past year and we are positioned well to continue that momentum into the future. Under the great leadership of Leslie Chapman, the section has continued its large growth in membership as well as enhancing the value that we deliver to our members.

The most tangible piece of value to our membership continues to be *Taxing Times*. Under the excellent direction of Brian King, this newsletter continues to be a top quality product. This newsletter is a great tool to help us grow our membership as well as provide educational value and updates on current topics.

The section has been increasing the continuing education opportunities for our members. More meetings and seminars are including sessions sponsored by the Taxation Section. For example, last year was the first time there was a tax session at the SOA Health Spring Meeting. We are also looking to be more involved with the Product Development Symposium and ReFocus (reinsurance).

The expansion of educational opportunities will be even more important with the SOA's creation of a Continuing Professional Development (CPD) requirement. This CPD requirement is expected to be effective on Jan. 1, 2009, with the first reporting as of Dec. 31, 2010. A draft exposure of the requirements can be found on the SOA Web site. Please take time to review the draft and comment on it by the Feb. 22, 2008 deadline.

The tax content in the SOA exam process has been broadened through the efforts of the Taxation Section. A great deal of hard work went into pulling together the tax content for the new FSA modules. Some modules include both U.S. and Canadian taxes and go into more depth than exams in the past. The effort will pay off in the future by increasing the number of new actuaries with an awareness of tax issues. The section will continue to monitor and modify exam material as needed.

The section council had a great planning meeting at the Annual Meeting in October. We are not only looking at what needs to be done over the next year, but where we want to be in five years. The section's activities and presence have been predominantly in the life insurance area, this has been based on the practice area of our volunteers. The section council would like to broaden our presence in other practice areas, as demonstrated with our session at the Health Spring Meeting. To broaden our presence in other practice areas, we need the help of our members in those areas. Please contact me if you would like to help in this effort.

I would like to thank Leslie for her most excellent leadership over this last year. She is a great asset and we are fortunate that she is still on the council. I would also like to welcome our four new council members: Chris DesRochers, George Hebel, Peter Marion and John Palmer. They make a great addition to our all-star cast of council members and friends of the council.

This year holds great potential for the Taxation Section. You too can be a part of fulfilling that potential and taking our section to new heights.

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

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A **unitary** valuation method considers the entire stream of future gross premiums and develops a proportional set of valuation net premiums. However, unitary reserves are sensitive to the slope of gross premiums. Under a level-premium policy, benefits are generally pre-funded. That is, the present value of future benefits exceeds the present value of future premiums, thus creating a positive reserve. However, a steeply sloped scale of gross premiums can result in the reserve system post-funding benefits. In that case, the present value of future premiums exceeds the present value of future benefits, thus creating a "negative" or zero reserve. A creative product designer can set unitary reserves at any desired level, simply by adjusting the scale of future gross premiums.

Over the years, the NAIC has proposed various reserve methods to deal with what was seen as the "unitary loophole" in the Standard Valuation Law. Actuarial Guideline IV, adopted in December 1984 and applicable to **term** insurance plans under the 1958 CSO used a term method, which required that a separate valuation net premium be computed for each term period. The approach chosen in the 1995 version of XXX, and carried forward to the current versions of XXX and AXXX, defines a **segment** method, in which a segment is defined by comparing the ratio of successive gross premiums (G_t) to the ratio of successive mortality rates (R_t) from tables applicable to deficiency reserves. Whenever the ratio of successive gross premiums is greater than the ratio of mortality rates, a new segment is created. Reserves are required to be the greater of the "segmented" or "unitary" valuation method. The result is a "humpback" pattern of statutory reserves. For a 20- to 30-year term policy, reserves may increase for the first 10 or 15 years, before ultimately leveling off and then declining. For longer term guarantees or SGUL, reserves may increase for periods as long as 20 to 30 years.

Deficiency Reserves

Before 1976, deficiency reserves equaled the present value of the excess of valuation net premiums over gross premiums. However, this led to the result that higher basic reserve standards translated to higher deficiency reserves. The 1976 amendments to the Standard Valuation Law defined an AMR (alternate minimum reserve) as the reserve based on minimum mortality and maximum valuation interest rate, replacing the valuation net premium by the gross premium for all years in which the actual gross premium is less than the minimum valuation net premium. In that case the Additional Reserve = AMR – Basic Reserve. If the gross premiums are always greater than the minimum modified net premiums, then no deficiencies are required. Under XXX, deficiency reserves are computed using the same method, either unitary or segmented, which resulted in the greatest basic reserve. The deficiency is equal to the excess of (A) over the basic reserve, where (A) is equal to the basic reserve recalculated by replacing the net premium by the gross premium in any year in which the modified net premium exceeds the gross premium.

Regulation XXX added "select" mortality factors to the 1980 CSO. The 2001 CSO is itself a select and ultimate table. Companies must use "standard" valuation mortality for basic reserves, although consistency between basic and deficiency reserves is not required. Regulation XXX also made changes in the permissible reserve mortality assumptions by allowing the use of "X factors" based on a company's expected mortality in the first segment of the deficiency reserve calculation. The effect is intended to reduce the amount of deficiency reserve.

Secondary Guarantee Universal Life

SGUL products provide a guarantee that the policy will remain in force based on the level of premiums paid under the contract. Many products accomplish this through a notional fund called a "shadow account" which provides that the secondary guarantee will be in effect so long as the shadow fund remains positive. The statutory reserves are based generally on the concept of a funding ratio, which represents the degree to which the secondary guarantee is "funded."[4] As the result of disagreements within the industry and the regulators as to the application of AXXX to these products, which are addressed in section 8 of Actuarial Guideline 38, there are three separate rules in effect, depending on the issue date of the underlying contract. Section 8A is effective for issues from Jan. 1, 2003 to July 1, 2005. section 8B, the so-called "CEO Compromise" is effective for issues from July 1, 2005 to Dec. 31, 2006, and section 8C, referred to as the "Interim Solution," is effective for issues from Jan. 1, 2007 to Dec. 31, 2010, when it is expected to be replaced by the introduction of principles-based reserves. The changes effective in January 2007 introduced a preferred risk version of the

[4] The "funding ratio" is similar to the "r" factor in the Universal Life Model Regulation. By minimizing the funding ratio, shadow fund design strategies can result in lower AXXX reserves.

2001 CSO Table, and allowed lapse rates to be used in the reserve mechanics.

Tax Reserves

Under the 1984 Tax Act, life insurance companies are permitted to deduct the increase in a "Federally prescribed reserve," (FPR) enabling the insurer to offset premium income by some measure of their expected future benefits. Under current law, section 807(c)(1) allows a deduction for life insurance reserves as defined in section 816(b)(1), in amounts described in section 807(d). Under section 807(d)(2), the amount of the reserve for any contract is determined using the tax reserve method applicable to the contract, the greater of the applicable federal or state assumed rate of interest, and the Commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks (*e.g.*, substandard risks) incurred under the contract which are not otherwise taken into account. Except for the designated tax reserve method, interest rate and mortality table, generally the FPR must be computed using the same actuarial basis as the statutory reserve.[5] For section 807(d) purposes, the "tax reserve method" varies depending on the type of contract at issue. For life insurance contracts, the tax reserve method is the Commissioners' Reserve Valuation Method (CRVM). By virtue of its adoption by the NAIC, the XXX segmented method serves as the tax reserve method beginning in 1995.[6] However, until the widespread adoption of the segmented methodology in 2000, generally, the "statutory cap" was the effective tax reserve, typically $\frac{1}{2}$cx.

Regardless of the basis of the statutory reserves, tax reserves are computed using the aggregate table. Section 807(d)(5)(E) requires that the table (and option thereunder) which generally yields the lowest reserves shall be used to determine the tax reserves.[7] It is generally agreed that the appropriate tax reserve is the basic XXX reserve computed using ultimate mortality.

Deficiency Reserves and the "Statutory Cap"

Generally, section 807(d)(1) imposes a two-part system for the deduction of life insurance reserves. The rules for computing the amount of life insurance reserves taken into account in computing a life insurance company's taxable income "require the insurance company to compare the net surrender value of the contract, the FPR for the contract, and the statutory reserve for the contract." Section 807(d) requires these comparisons to be made on a contract-by-contract basis. As a result, the allowable reserve necessarily falls in a range bounded by the net surrender value (a floor) and the annual statement reserve (a ceiling). The limitation based on the annual statement reserve is commonly referred to as the "statutory cap." Thus, if the statutory cap falls below the FPR, the cap becomes the deductible amount.

For XXX contracts issued before 2000, as well as contracts with select and ultimate reserves, there are occasions where the statutory cap controls the tax reserve. Generally, deficiency reserves are not deductible.[8] However, the issue of whether a deficiency reserve is a part of the statutory cap remains unresolved, with some indications that the IRS believes that deficiency reserves should be excluded from the statutory cap, despite a strongly held taxpayer view that deficiency reserves are in fact a part of the statutory cap. Resolution of this issue will have an impact on XXX reserves, particularly for pre-2000 tax years.[9]

New Valuation Tables

Part of the so-called "Interim Solution" was the promulgation of the NAIC *Model Regulation Permitting*

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[5] In computing tax reserves, the effect of deferred and uncollected premium and excess interest must also be eliminated from the statutory reserve.

[6] *See* TAM 200328006. The effective dates of actuarial guidelines are the later of the effective date or the date adopted by the NAIC. However, the 2007-2008 Treasury Priority Guidance Plan indicates the IRS is considering a revenue ruling on the meaning of the term "statutory reserves" under section 807 "where the company is subject to different statutory requirements in different states." This may clarify the IRS view of the effective date of XXX in various states. *See* Peter H. Winslow and Samuel A. Mitchell, "IRS to Rule on the Meaning of Statutory Reserves," this issue of *Taxing Times*, 30.

[7] Rev. Rulings 87-26 and 92-19. The 1980 CSO without select factors produces the lowest tax reserve on an industry-wide basis. Similarly, the 2001 CSO Academy Report to LHATF indicates the 2001 CSO Ultimate generally produces lower reserves.

[8] *See* Code section 816(h). Treatment of deficiency reserves.--For purposes of this section and section 842(b)(2)(B)(i), the terms "life insurance reserves" and "total reserves" shall not include deficiency reserves.

[9] *See* Peter H. Winslow and Lori J. Jones, "The Statutory Cap on Tax Reserves Includes Deficiency Reserves," *Taxing Times,* Vol. 2 Issue 2, September 2006, 14.

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the Recognition of Preferred Mortality Tables for Use in Determining Minimum Reserves, which allows states to adopt "preferred" versions of the 2001 CSO prepared for the American Council of Life Insurers (ACLI) by Tillinghast. The table provides mortality rates for super preferred, preferred, and residual nonsmokers, as well as preferred and residual smokers. The preferred table is permitted for valuation only, and has limitations on its use. The plans to which it is applied must have preferred mortality classes, and the use of the tables is based on actuarial certification of mortality. Actuarial Guideline TAB (AG42) provides guidance in selecting preferred tables. State adoptions of the table are currently in progress. Under AG TAB, if a company used the 2001 CSO Preferred Tables for basic reserves, they must also be used for deficiency reserves.

Section 807(d)(5)(A) defines the term "prevailing commissioners' table" as "the most recent commissioners' standard tables prescribed by the NAIC which are permitted to be used in computing reserves . . . under the insurance laws of at least 26 States when the contract was issued." As the preferred table is subject to some limitations on use, it is not clear as to whether it will be considered a prevailing table upon its adoption by 26 states. In the aggregate, the 2001 CSO Preferred table produces the same reserves as the 2001 CSO smoker and nonsmoker tables. However, as proportion of preferred business changes, the aggregate reserves are lower under the preferred table. Similarly, there are instances in which the select and ultimate tables result in lower reserves than the ultimate table. This could create some issues under the section 807(d)(5)(E) "lowest reserve" rule. The preferred 2001 CSO is seen as an interim step, as the Society of Actuaries is currently developing a "scientific" preferred mortality table. How and when this may impact tax reserves also remains an open issue.

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Factors Other Than Mortality and Interest

One of the other changes in the computation of reserves for SGUL was the introduction of a lapse factor into the computation of statutory reserves. Section 8C provides that, for certain issue ages and policy durations, a specified lapse rate (either 2 percent or 1 percent) "may be used" in the reserve calculation. The effect of the use of the lapse factor is to reduce the reserve. It is not clear as to how this affects the tax reserve (except perhaps through the statutory cap). One view is that tax reserves are fully defined by the FPR in section 807(d), and that only interest and mortality are used. Another view is that courts have generally permitted factors other than interest and mortality to be recognized in the calculation of life insurance reserves, so the use of a lapse rate should follow the statutory calculation, which follows the logic that tax reserves are statutory reserves, which are adjusted by the FPR limitations. Resolution of this issue may have an implication for the tax issues surrounding PBR.

IRS Comments

The debate continues as to whether the XXX and AXXX reserves are unnecessary and redundant.[10] However, redundant or not, the pattern of reserves that emerges under XXX creates a significant need for additional capital to fund the reserves. Insurers have dealt with the issue in a number of ways including reinsurance, surplus notes and securitizations. From a federal income tax perspective, these transactions deal with the reserve deductions in different ways, but one structure is to reinsure the AXXX and XXX reserves to a downstream onshore captive, which preserves the potential tax benefits of the reserve deduction. One way in which this is accomplished is to issue a bond in the subsidiary that serves to collateralize the reserves in the downstream company.[11]

The securitization activity has apparently attracted the attention of the Internal Revenue Service (IRS). In a conference last October, representatives of the IRS Large and Midsize Business Division (LMSB) commented that the IRS would begin to study life insurance securitizations, focusing on the relationship of the investors to the insurance risk that is being securitized. Given the timing of the audit cycle, the IRS is now beginning to audit tax years in which the securitizations first appeared. The questions raised by the IRS address a series of issues that have no immediate answer. While the IRS does not appear to have any specific guidance in mind, one issue may be the characterization of the assets of the reinsurer. Although most observers would describe an XXX securitization as debt, the IRS could argue for equity treatment based on participation of the investors in the mortality experience of the underlying block of business. Treatment as equity would affect the deductibility of interest paid to the bondholders. Whatever the outcome, it appears to signal the beginning of another chapter in the XXX and AXXX saga, one that the life insurance industry hopes will not be X-Rated.

[10] In fact, the reserves are often segmented into "economic" and "non-economic" elements.

[11] For a detailed discussion of tax issues involved in XXX securitizations, *see* Michael A. Bell, "Removal of Profit/Loss Separation Rule from Life-Nonlife Regulations Eliminates Tax Issue from Securitizing Triple-X Business," *Taxing Times*, Vol. 2 Issue 2, September 2006, 18.

Time to Say Goodbye to the 1980 CSO Mortality Table

by Brian G. King and Craig R. Springfield

In the race towards a new mortality table, the finish line is coming up fast. At the finish, the new 2001 CSO Mortality Table will be crowned victorious, at least for a while, and the 1980 CSO will be a table of the past. As the final lap to the finish begins, companies must ensure that significant and necessary product development, and administrative and compliance system changes, have been completed and tested. All systems must be able to accommodate the new table.

The race towards a new CSO table began in December, 2002, when the National Association of Insurance Commissioners (NAIC) adopted the Model Regulation recognizing the 2001 CSO Mortality Tables. In this first lap, the life insurance industry began what would turn out to be a six-year transition process. The Model Regulation adopted in 2002 recognized the 2001 CSO tables, permitted their use, and prescribed how they shall be used. The Model Regulation also provided a transition period that would allow life insurance companies time to transition products to the new mortality table. That transition period is set to close at the end of this calendar year, on Dec. 31, 2008. All 50 states have now adopted the Model Regulation. Thus, beginning Jan. 1, 2009, all life insurance products sold in the United States must satisfy both the state minimum nonforfeiture law requirements and the state minimum reserve requirements using 2001 CSO mortality.

Since 2002, there have been SOA-sponsored seminars dedicated to the 2001 CSO tables, countless sessions at SOA meetings, and numerous articles written that address the implications of adopting a new CSO mortality table. In addition, clarity has been brought to a number of issues through published guidance from the Internal Revenue Service (IRS) and the Department of the Treasury (Treasury). This is well and good, since the final lap is underway and the finish line is in sight. (And as discussed below, the finish line is already here in some respects.) For some companies, the race is complete, as their portfolios have successfully been converted and their administrative systems have been successfully modified to support the 2001 CSO tables. Others are hastily working toward achieving this goal. This article is intended to provide a checklist to help those navigating through the final hurdles of their efforts to implement the change to the 2001 CSO tables, focusing on the key dates and transition issues that will effectively sunset

the 1980 CSO tables, and also on points to consider to ensure ongoing product tax compliance for 2001 CSO products.

Section 807 Tax Reserves

As a general matter and as stated above, beginning Jan. 1, 2009, all life insurance products sold in the United States must satisfy both the state minimum nonforfeiture law requirements and the state minimum reserve requirements using 2001 CSO mortality. From that point forward, reserves on both a statutory and tax basis must be based on 2001 CSO mortality. However, use of 2001 CSO is required in other instances as well.

According to section 807 of the Internal Revenue Code (Code), tax reserves are the greater of (1) the net surrender value of the contract, or (2) the reserve computed under federally prescribed standards (*i.e.,* the "Federally Prescribed Tax Reserves," or FPTR). In no event, however, can tax reserves exceed statutory reserves. The FPTR is the reserve determined by using (a) the tax reserve method applicable to such contracts, (b) the greater of the applicable Federal interest rate or the prevailing State assumed rate, and (c) ***the prevailing Commissioners' Standard Table*** for mortality adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account.

When section 807 was created, Congress had the foresight to build-in transition rules to address the adoption of a new prevailing table. These transition rules allow for the use of both the "old" and the "new" tables for a

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period of three calendar years that begins on January 1 of the year (referred to in section 807(d)(5)(B) as the "year of change") that follows the year when a new prevailing table arises. Since the 2001 CSO tables became the ***prevailing Commissioners' Standard Table*** during 2004 following the adoption of the Model Regulation by the 26th state, the mortality tables' "year of change" was 2005, and thus the 1980 CSO tables continued to be permitted for use as the prevailing tables under section 807 until after "the three-year period beginning with the first day of the year of change," *i.e.,* through Dec. 31, 2007. Thus, beginning Jan. 1, 2008, the 2001 CSO became the required table for use in computing reserves for tax purposes. However, it is not until Jan. 1, 2009 that the 2001 CSO will become the required table for state minimum nonforfeiture values. Companies should be aware of this 12-month differential and recognize that tax reserves for 1980 CSO products issued in 2008 must be based on 2001 CSO mortality.

Section 7702(c)(3)(B)—Reasonable Mortality Requirements

Both sections 7702 and 7702A of the Code impose funding limitations on life insurance contracts. Companies must insure that contracts are administered within these funding limitations so that the life insurance contracts retain their favorable tax treatment. These limitations place restrictions on both the allowable premiums paid into a life insurance contract and the allowable cash value for a given death benefit. In defining these actuarial limitations, section 7702(c)(3)(B)(i) requires the mortality used to be "reasonable." While not directly defining the term reasonable, section 7702(c)(3)(B)(i) goes on to additionally require that the mortality charges assumed must meet "the requirements (if any) prescribed in regulations and which (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is issued."

The reasonable mortality charge requirement is tied to the ***prevailing Commissioners' Standard Tables*** as defined in section 807(d)(5). As previously discussed above, the 2001 CSO tables became "prevailing" during 2004, starting the clock on a three-year transition period, ending Dec. 31, 2007, during which both the 1980 and 2001 CSO tables would be considered prevailing tables. Assuming the three-year transition period provided in section 807 carries over to section 7702, use of the 2001 CSO tables would be required for contracts issued after Dec. 31, 2007, which could create difficulties for 1980 CSO contracts with respect to satisfying the reasonable mortality requirements of section 7702.[1]

To alleviate some of this uncertainty, the IRS issued Notice 2006-95[2] (released in October 2006), which provides guidance on the transition to the 2001 CSO tables for purposes of satisfying section 7702's reasonable mortality requirement. More specifically, Notice 2006-95 provides for "safe-harbors" with respect to the reasonable mortality charge requirements of section 7702(c)(3)(B)(i). By meeting one of these safe harbors, companies can be assured that their life insurance contracts will satisfy section 7702's reasonable mortality requirements.

- Notice 88-128 Safe Harbor: Notice 2006-95 provides that the interim rules described in Notice 88-128 remain in effect, except as modified by Notice 2006-95.

- 1980 CSO Safe Harbor: A mortality charge with respect to a life insurance contract will satisfy the requirements of section 7702(c)(3)(B)(i) so long as (1) the mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 1980 CSO tables; (2) the contract is issued in a state that permits or requires the use of the 1980 CSO tables at the time the contract is issued; and (3) the contract is issued before Jan. 1, 2009. It appears critical that 1980 CSO contracts meet this safe harbor or the Notice 88-128 Safe Harbor if they are issued during 2008 and cover a standard risk insured, since it may not otherwise be possible for such designs to comply with the statute. This is because calculations under sections 7702 and 7702A for such a contract not meeting one of these safe harbors would need to use 2001 CSO mortality.

[1] The potential exists for state law minimum cash values (nonforfeiture values) to exceed federal maximums for traditional whole life contract designs that are intended to comply with the cash value accumulation test of section 7702(a)(1).

[2] Notice 2006-95 supplements Notice 88-128, 1988-2 C.B. 540, and modifies and supersedes Notice 2004-61, 2004-2 C.B. 596. Notice 2004-61 also addressed the transition to the 2001 CSO tables.

- 2001 CSO Safe Harbor: A mortality charge with respect to a life insurance contract will satisfy the requirements of section 7702(c)(3)(B)(i) so long as (1) the mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 2001 CSO tables; (2) the mortality charge does not exceed the mortality charge specified in the contract at issuance; and (3) either (a) the contract is issued after Dec. 31, 2008, or (b) the contract is issued before Jan. 1, 2009, in a state that permits or requires the use of the 2001 CSO tables at the time the contract is issued.

There are several characteristics of the 2001 CSO tables that distinguish it from prior CSO tables, most notably a 25-year select period and the extension of the table beyond age 100.

While Notice 2006-95 provides safe harbors for both 1980 and 2001 CSO products, an important distinction exists in how the safe harbors are defined. For life insurance products designed to comply with the 2001 CSO Safe Harbor, companies will need to consider whether the contract in some way guarantees mortality charges that are less than 100 percent of the 2001 CSO tables (*e.g.*, guarantying "current" mortality rates for the first year). If so, it would be necessary to reflect these lower rates in the calculations under sections 7702 and 7702A in order to meet the safe harbor requirements for this table. A similar requirement does not exist with respect to the 1980 CSO safe harbors.

Maturity Date Implications of the 2001 CSO Mortality Tables

There are several characteristics of the 2001 CSO tables that distinguish it from prior CSO tables, most notably a 25-year select period and the extension of the table beyond age 100. These raise some fundamental questions regarding how calculations should be made for such contracts under sections 7702 and 7702A.

Can benefits beyond age 100 be reflected in the calculation of guideline, net single and 7-pay premiums?

Is the application of the guideline premium test limited by the assumptions underlying the calculation of the premiums themselves?

Can a company assume the Section 7702(d) corridor factors extend to age 120?

How should the cash value accumulation test be administered beyond age 100?

These questions are linked to the computational rules of section 7702(e)(1), which limit future benefits that can be incorporated into the calculation of guideline, net single, and 7-pay premiums. In particular, section 7702(e)(1)(B) provides that the maturity date assumed in the calculation can be no earlier than the day on which the insured attains age 95 and no later than the day on which the insured attains age 100.

The insurance industry has requested guidance from Treasury and the IRS on the proper application of the current computational rules to the 2001 CSO Mortality Table but, to date, such guidance has not been provided. To help companies deal with the uncertainty created from the structure of the 2001 CSO tables, the Taxation Section of the Society of Actuaries established the ***2001 CSO Maturity Age Task Force***. The purpose of the task force was to propose methodologies that would be actuarially acceptable under sections 7702 and 7702A for calculations under contracts that do not provide for an actual maturity before age 100.[3] The recommendations put forth by the 2001 CSO Maturity Age Task Force are as follows:

- Calculations will assume that all contracts will pay out in some form by age 100, as presently required by the Code, rather than by age 121 as would occur "naturally" under the 2001 CSO.

- The net single premium used in the cash value accumulation test corridor factors, of section 7702(b), and the necessary premium calculations, of section 7702A(c)(3)(B)(i), will be for an endowment at age 100.

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[3] While these recommendations do not represent formal guidance with respect to establishing compliance with the section 7702 and 7702A requirements, they do provide insight as to how companies are modifying their administration systems to support the 2001 CSO tables.

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- The guideline level premium present value of future premium calculations, of section 7702(c)(4), will assume premium payments through attained age 99.

- The sum of guideline level premiums, of section 7702(c)(2)(B), will continue to increase through attained age 99. Thereafter, premium payments will be allowed and will be tested against this limit, but the sum of guideline level premiums will not increase. If the guideline level premium is negative, the sum of guideline level premiums will also not decrease after age 99.

- In the case of contracts issued or materially changed near to the insured's age 100, the modified endowment contract (MEC) present value of future premium calculations will assume premium payments for the lesser of seven years or through age 99. This is the case because the computational rules of section 7702A(c)(1) provide: "Except as provided in this subsection, the determination under subsection (b) of the 7 level annual premiums shall be made … by applying the rules … of section 7702(e)," suggesting a need for a new seven-pay premium. However, since section 7702(e)(1)(B) requires a maturity date of no later than the insured's attained age 100, it arguably overrides the computational rules of section 7702A(c)(1) and thus the calculations would end at age 100. Given the lack of guidance, reasonable alternative interpretations may also be available on this point.

- If the MEC present value of future premium calculations assumes premium payments through age 99 but this is less than seven years, the sum of the MEC premiums will continue to increase through attained age 99. Thereafter, premium payments will be allowed and will be tested against this limit for the remainder of the seven-year period, but the sum of MEC premiums will not increase after age 99.

- In the case of contracts issued or materially changed near to the insured's age 100, followed by a reduction in benefits, the MEC reduction rule, of section 7702A(c)(2), will apply for seven years from the date of issue or the date of the material change for a single life contract. For contracts insuring more than one life, the MEC reduction rule, of section 7702A(c)(6), will apply until the youngest insured attains age 121.

- Adjustments that occur on or after attained age 100 will not necessitate a material change for MEC testing purposes or an adjustment event for guideline premium purposes.

- Necessary premium/deemed cash value testing, of section 7702A(c)(3)(B)(i), will cease at attained age 100.

- Policies can remain in force after age 100 with a death benefit greater than or equal to the cash value.

The 2001 CSO and Attained Age Regulation §1.7702-2

In September 2006, Treasury and the IRS issued final regulations providing guidance on the determination of an insured's "attained age" for certain purposes under sections 7702 and 7702A. The regulations became effective Sept. 13, 2006 and apply to policies either (a) issued after Dec. 31, 2008, or (b) issued on or after Oct. 1, 2007 and based on the 2001 CSO tables. A taxpayer may choose to apply the final regulations to policies issued prior to Oct. 1, 2007 provided that the taxpayer does not later determine the policies' qualification in a manner that conflicts with the regulations. The effective dates of this regulation were intentionally designed to coincide with the 2001 CSO effective dates contained in the NAIC's Model Regulation so as to coordinate with state filings and changes in compliance systems needed due to both the new attained age rules and the transition to the 2001 CSO tables.

However, guidance contained in the regulation imposes requirements, applicable for certain purposes, that run

contrary to how certain life insurance companies design and administer their contracts. In particular, under these requirements, companies cannot use derived ages for multiple life contracts. This would include the use of a "joint equal age" for contracts insuring more than one life and the use of a "rated age" to reflect a substandard mortality risk associated with a particular insured. These requirements, on their face, apply for purposes of section 7702(c)(4), which relates to the guideline level premium, section 7702(d), which relates to the cash value corridor requirement, and section 7702(e), which relates to computational rules (including the rule requiring that the deemed maturity date assumed be no earlier than the insured's age 95 and no later than the insured's age 100).

A second issue affects the administration of off-anniversary changes. The final regulations state that: *"Once determined, … the attained age with respect to an individual insured under a contract changes annually."* [4] (Emphasis added.) This approach runs contrary to a common insurance industry practice with regard to off-anniversary death benefit increases. Many administrative systems apply a "segment approach" to death benefit increases, where each segment, or layer, of additional death benefit is administered independently from the base contract. Each segment is assigned its own issue date, coverage amount, issue age, etc., and the system calculates guideline premiums according to the characteristics assigned to each segment. Under a segment approach, the system would aggregate guideline or net single premiums for each segment to determine the premiums applicable to the contract. Also, administration systems are commonly programmed to determine issue age for the segment as if the segment were viewed as a newly issued contract. If the contract defines age on an age-last-birthday basis, the segment issue age would be determined on an age-last-birthday basis as of the segment effective date. Thus, the segment issue age under an age-last-birthday determination may be greater than the attained age permitted under the final regulations, resulting in a potential overstatement of guideline or net single premiums.

In addition, section 7702A(c)(3)(A)(i) material changes create a rather odd tension with the "attained age" rules contained in this regulation. Upon a material change in benefits under a contract which was not reflected in any previous determination under section 7702A, section 7702A(c)(3)(A)(i) requires the contract to be treated as "a new contract entered into on the day on which such material change takes effect." How does this language reconcile with the language in the regulation that states that age, once determined, changes annually? Could it be that there is a different attained age for section 7702A calculations than for section 7702 calculations? Let's look at an example:

Under a segment approach, the system would aggregate guideline or net single premiums for each segment to determine the premiums applicable to the contract.

> *Example:* An insured born on May 1, 1947 purchases a policy on Jan. 1, 2008. January 1 is the contract anniversary date for future years. The face amount of the contract is increased on May 15, 2011. During the contract year beginning Jan. 1, 2011, the age assumed under the contract on an age-last-birthday basis is 63 years. However, at the time of the face amount increase the insured's actual age is 64. Treas. Reg. section 1.7702-2(b)(2) provides that, once the attained age is determined, it remains that age until the next policy anniversary. Thus, the insured continues to be 63 years old throughout the contract year beginning Jan. 1, 2011 for purposes of sections 7702(c)(4), 7702(d) and 7702(e), as applicable, even though the insured is age 64 at the time of the increase based on an age-last-birthday determination.

Under this example, if the contract is considered newly entered into on the date of the face amount increase (May 15, 2011), is it then appropriate to determine age as if the contract were newly entered into on that date for purposes of section 7702A(c)(3)(A)? It would seem so, in which case the attained age for the 7-pay premium calculation in the example is 64. While calculations of 7-pay premiums under section 7702A are made, in part, using the computational rules of section 7702(e), section 7702A(c)(3)(A)(i) appears to be the more specific statutory rule governing the date when calculations are made and an insured's age is identified for purposes of the

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[4] Section 1.7702-2.

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section 7702A(c)(3) material change rule. Additional guidance on this issue would be helpful.

Final Thoughts

These are just some of the implications facing companies as they enter this final lap in the race to the new 2001 CSO tables. Much of what is written here summarizes articles previously published in *Taxing Times*, including:

> *Evolution of the Mortality Requirements under Sections 7702 and 7702A of the Internal Revenue Code,* Christian DesRochers (May 2005, Vol. 1 Issue 1)
>
> *2001 CSO Implementation Under Sections 7702 and 7702A, the 2001 CSO Maturity Age Task Force,* (May 2006, Vol. 2 Issue 1)
>
> *More on Reasonable Mortality: IRS Issues Notice 2006-95,* Brian G. King, John T. Adney and Craig R. Springfield, (Feb. 2007, Vol. 3 Issue 1)
>
> *Age Defined: IRS Issues Final Regulations on "Attained Age" Under Section 7702*, Brian G. King, John T. Adney and Craig R. Springfield, (May 2007, Vol. 3 Issue 2)

Readers should revisit these previously published articles for a more in-depth discussion on these topics.[5] The finish line is rapidly approaching. It's time to bid a fond farewell to the 1980 CSO. System modifications necessary to support the new requirements must be tested and implemented. The 2001 CSO is here. Are you ready?

[5] Prior issues of *Taxing Times* can be viewed on-line by visiting the Taxation Section webpage on the Society of Actuaries Web site at *www.soa.org.*

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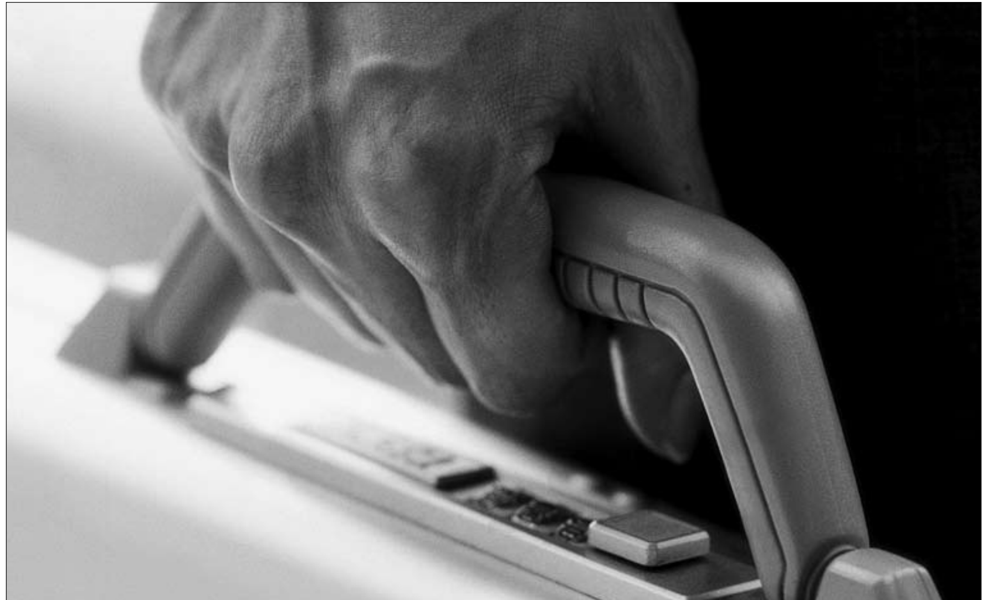
I-COLI: The Genesis of Revenue Procedure 2007-61 and the Future of Insurer-Owned Life Insurance

by John T. Adney, Kirk Van Brunt and Michelle A. Garcia

On Sept. 11, 2007, the Internal Revenue Service (IRS) took the unusual, but altogether welcome step, of issuing a revenue procedure to overturn a private letter ruling. Revenue Procedure 2007-61, 2007-40 I.R.B. 747, announced a safe harbor rule under which an insurance company may own life insurance policies on its employees—corporate-owned life insurance (COLI) typically held to fund the employer's post-retirement health care liabilities—without forfeiting a portion of its reserve deductions. The private letter ruling (PLR 200738016) had said the contrary, placing insurers at a unique disadvantage *vis-à-vis* banks and other corporations, which can hold COLI on their employees without losing any deductions. The tale of the journey from the adverse private letter ruling to the issuance of the revenue procedure, and some speculation about the future, is the subject of the following discussion.



Background

As part of the Taxpayer Relief Act of 1997 (the 1997 Act), Congress enacted section 264(f)[1] to discourage financial institutions (and others) from purchasing life insurance for their own account on the institutions' customers. The provision did this by denying, in section 264(f)(1), interest deductions in accordance with a "proration" formula if coverage containing "unborrowed cash values" was purchased on the life of an individual other than one in a permitted class, *i.e.*, an officer, employee, director or 20 percent owner of the purchasing entity as described in section 264(f)(4)(A). Under the formula, in very general terms, the otherwise deductible interest is reduced by the ratio of the unborrowed cash values to the average adjusted bases of the taxpayer's overall assets (including the unborrowed cash values). Since banks credit a great deal of interest to depositors and seek to deduct it on their income tax returns, the effect of the provision was precisely what Congress intended: it has limited banks (and like institutions) to purchasing COLI only on members of a section 264(f)(4)(A) permitted class.

At the same time it enacted section 264(f), in the very same section of the 1997 Act, Congress enacted parallel rules for insurance companies.[2] Congress knew that disallowing interest deductions would have only limited effect on insurance companies, which generally do not have large amounts of deductible interest as compared with banks. Hence, in lieu of an interest deduction restriction, Congress imposed rules causing the loss of reserve deductions where the taxpayer is an insurance company subject to taxation under Subchapter L (sections 801-848). *See* section 264(f)(8)(B) (rendering section 264(f) technically inapplicable to insurance companies). Specifically, if a life insurance company holds life insurance policies with unborrowed cash values otherwise described in section 264(f), the amount of the reserve increase or decrease taken into account in computing the company's taxable income is reduced to reflect such unborrowed cash values. *See* sections 807(a)(2)(B)

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[1] Unless otherwise indicated, all references to "sections" are to sections of the Internal Revenue Code of 1986, as amended.

[2] *See* section 1084 of the 1997 Act.

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and 807(b)(1)(B). In the case of a property and casualty (non-life) insurance company holding such policies, the amount of the company's losses incurred deduction is reduced. *See* 832(b)(5)(B)(iii). These rules, which state that they apply to "life insurance policies and annuity and endowment contracts to which section 264(f) applies," operate by treating the policies' cash values in the same manner as other tax-favored income items under the proration rules generally applicable to insurers. *See* sections 805(a)(4)(C)(ii), 805(a)(4)(D)(iii), and 805(a)(4)(F) (life insurance companies); section 832(b)(5)(B)(iii) (non-life insurance companies).

The Private Letter Ruling

Significantly, the just-quoted reference to "contracts to which section 264(f) applies" in the Subchapter L rules turned out to be the source of controversy. To date, almost all insurance companies and their tax advisors have read that phrase to encompass life insurance contracts that would have given rise to the interest deduction disallowance under section 264(f) if that provision were applicable to insurers. More particularly, the phrase has been understood to exclude from the proration disallowance rules those contracts that cover permitted classes of insureds—again, contracts that insure officers, employees, directors, and 20 percent owners and, thus, fall within the section 264(f)(4)(A) exception. Such contracts, in other words, are not "contracts to which section 264(f) applies." This interpretation permits insurance companies, like banks and other corporations, to purchase life insurance on their officers, employees and directors without forfeiting income tax deductions otherwise allowable. As a consequence of this interpretation, many insurers have acquired such coverage, which Revenue Procedure 2007-61 dubbed "I-COLI."

A very different view was taken, at least initially, by the IRS National Office. As we reported in the September 2007 issue of *Taxing Times*, a private letter ruling was issued on May 3, 2007, holding that the Subchapter L proration disallowance rules attach whenever an insurance company holds life insurance with unborrowed cash values—regardless of who is insured under them. The ruling effectively denied insurers the same treatment as banks and other corporations, which can purchase life insurance on their officers, employees and directors without losing income tax deductions. The ruling was released to the American Council of Life Insurers (ACLI) by the taxpayer that obtained it. For reasons discussed below in connection with the ruling's reconsideration, the ruling was not released to the public by the IRS after the usual 90-day interval, but instead was released coincident with the issuance of the revenue procedure under the number 200738016.

How did the IRS come to this viewpoint? In reaching its conclusion in the private letter ruling, the IRS reasoned that the pertinent Subchapter L rules referred to "contracts to which section 264(f) applies," not to "contracts to which section 264(f)(1) applies." The absence of the reference to paragraph (1) of subsection (f) in the Subchapter L rules was vital to the IRS's reasoning, particularly in view of the fact that in section 264(f) itself, the section 264(f)(4)(A) exception says that paragraph (1) of section 264(f) will not apply to contracts that qualify for the exception, *i.e.,* contracts covering permitted classes. Section 264(f)(4)(A) does not say that section 264(f) in its entirety does not apply if the exception applies, and yet the Subchapter L rules only speak of contracts to which section 264(f) in its entirety applies. So, in view of the words of these statutory provisions, the IRS adopted this syllogism: (1) the proration disallowance rules in Subchapter L, the counterpart to section 264(f), apply to any contract to which section 264(f) applies; (2) contracts covering permitted classes within the meaning of section 264(f)(4)(A) are excluded from section 264(f)(1), but not from section 264(f) in its entirety; and (3) therefore, all life insurance contracts held by insurance companies are subject to the proration disallowance rules because they are all subject to section 264(f). This reading of the statute, of course, produces a result in stark contrast to banks and other financial institutions, which are not subject to interest expense disallowance in the case of contracts covering permitted classes. Left unexplained by the IRS in PLR 200738016 is why Congress would want to differentiate between insurance companies on the one hand and banks and other financial institutions on the other hand, imposing a far harsher disallowance regime on insurers with respect to life insurance they hold. In the absence of any explanation by Congress, that would seem to be an absurd result.

One might defend the IRS's statutory reading in PLR 200738016 as being a strictly literal reading of the plain words of the statute, but it is questionable whether the IRS actually interpreted the plain words of the statute correctly even from a strictly literal perspective. There is yet a third point of view that could be taken of the critical phrase in the Subchapter L rules, although understanding it may lead to the conclusion that the statutes were not well crafted and thus incapable of a strictly literal interpretation. The third view is that in the

context of the Subchapter L rules, "contracts to which section 264(f) applies" consists of a null set, since according to section 264(f)(8)(B), section 264(f) does not apply to taxpayers subject to Subchapter L. Since section 264(f) does not apply to such taxpayers, it necessarily follows that it cannot apply to any contracts they hold. In other words, the Subchapter L rules are, to recall a term from late in the Nixon Administration, "inoperative," and one reaches the exact opposite conclusion that the IRS reached: viz., *all* contracts held by insurers (not just those covering permitted classes) are exempt from the proration disallowance rules. From a strict statutory construction standpoint, reading the terms as written by Congress most literally, this third interpretation is the correct one. But if "the life of the law has not been logic: it has been experience,"[3] this reading cannot be right, for experience teaches that statutory language is not to be construed as a nullity.

In sum, a strictly literal reading of the plain words of the statute produces two diametrically opposed interpretations, neither of which makes much sense. Manifestly the "plain" words of the statute turn out to be not so plain after all. In such situations, it therefore becomes necessary to consult legislative history and tax policy before reaching a conclusion. The legislative history of the Subchapter L rules is not directly helpful in this exercise, apart from showing that Congress wrote those rules at the same time it wrote section 264(f) and the exception for permitted classes—although the fact that the legislative history definitely does not express any intent on the part of Congress to discriminate against insurers in regard to the ownership of COLI covering only insureds in the permitted classes does weigh against concluding that Congress intended this in drafting the statutory language. Tax policy, on the other hand, should be singularly helpful in the construction of the pertinent rules. From the standpoint of sound tax policy, there is no reason to enable financial institutions (and other types of businesses) generally to hold COLI on their officers, employees, and directors with no tax-based impediment while deploying the tax system to deny this ability to corporations doing an insurance business. Unfortunately, the private letter ruling did not discuss the tax policy considerations, and apparently did not employ them in reaching its conclusion.

The Revenue Procedure

After receiving insurance industry protest against PLR 200738016, particularly from the ACLI, and after considering the matter in conjunction with the Treasury Department, the IRS issued Revenue Procedure 2007-61, effective Sept. 11, 2007. Section 4 of the revenue procedure created a safe harbor, providing that:

> For purposes of applying the insurance company proration rules in §§ 807(a)(2), 807(b)(1), 805(a)(4), 812, or 832(b)(5), an insurance company is not required to take into account any portion of the increase for the taxable year in the policy cash values (within the meaning of section 805(a)(4)) of I-COLI contracts.

Tax policy, on the other hand, should be singularly helpful in the construction of the pertinent rules.

However, as an important constraint on this safe harbor, the revenue procedure extended its relief only to I-COLI contracts "covering no more than 35 percent of the total aggregate number of the individuals described in § 264(f)(4)(A) [*i.e.*, the permitted classes of insureds] at any time during the taxable year." *See* section 3 of Rev. Proc. 2007-61 ("Scope"). At the same time it issued the revenue procedure, the IRS finally released to the public PLR 200738016, which had been circulating informally. However, in consequence of the issuance of the revenue procedure, the IRS also issued PLR 200738017 (Sept. 21, 2007), which modified PLR 200738016 to incorporate the new safe harbor rule.

The revenue procedure, in other words, suspended the application of the I-COLI-related Subchapter L proration rules, allowing insurers to hold COLI on permitted classes of insureds in the same manner as other businesses, but it did so only with respect to contracts falling within its 35 percent limitation. While this generally provided good news for insurers, one might ask what is the source and purpose of the 35 percent limitation. The 35-percent-of-permitted-classes limit was *sui*

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[3] Holmes, Oliver Wendell, Jr., *The Common Law*, at 8 (Mark DeWolfe Howe, ed.) (Back Bay Books, 1963). *The Common Law* was first published in 1880.

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generis in the revenue procedure, as nothing in section 264(f) or the pertinent Subchapter L rules reference any such limit. That said, it should be obvious to anyone knowledgeable of recent legislative developments affecting COLI that the source of the new safe harbor's limit lies in one of the provisions of section 101(j), enacted by the Pension Protection Act of 2006. In particular, by virtue of section 101(j)(2)(A)(ii)(III), the section 101(j)(1) inclusion of death benefits under "employer-owned life insurance" in the employer's taxable income does not apply to coverage on the lives of the top 35 percent of the workforce, determined by compensation and otherwise applying the rules of section 105(h). For this purpose, the top 35 percent is measured by aggregating all employees of the employer and its affiliates. The revenue procedure's 35 percent limit could be invoking a similar rule, by virtue of the aggregation rule found in section 264(f)(8)(A), although the wording of section 3 of the revenue procedure refers only to "35 percent of the total aggregate number of the individuals described in § 264(f)(4)(A)."

Regardless of the scope of the new 35 percent limit, it remains to consider why the revenue procedure imposed it when the Subchapter L rules (and section 264(f) itself) are silent in this respect. The revenue procedure is equally silent on the purpose of imposing the limit, but one might infer one or both of two possible purposes behind its imposition. One would be a desire to parallel the latest thinking of Congress of the permissible reach of broad-based COLI arrangements. If so, then resort to some sort of 35 percent limit might be appealing from a tax policy standpoint. Another possibility would lie in a need, in granting a "safe harbor," to condition the favorable treatment granted by the revenue procedure on compliance with some external constraint. If this were not done, then the IRS could be seen as simply "giving up" on the position taken in PLR 200738016, a step eschewed by the drafters of the revenue procedure (see section 2.02, third sentence, of the revenue procedure).

The 35 percent limitation aside, Revenue Procedure 2007-61 provided more good news, and some other news, too. Section 4 of the revenue procedure provided that its safe harbor applies "pending the publication of additional guidance," and section 5 thereof went on to state that additional guidance, if any, published interpreting the phrase "contracts to which section 264(f) applies" will apply prospectively. As for the other news, the revenue procedure states that I-COLI contracts will "remain subject to challenge under other provisions of the tax law, including judicial doctrines such as the business purpose doctrine."

In section 6 of the revenue procedure, the IRS requested comments by Dec. 31, 2007, on "the need for additional guidance in this area." Going beyond the issue of the proper construction of the Subchapter L rules, and likely relating back to the just-quoted statement that I-COLI contracts will remain subject to challenge under other provisions of the tax law, the IRS specifically asked for comments regarding the "existence of any non-tax regulatory rules or other requirements that limit an insurance company's ability to invest in I-COLI contracts and the effect of any experience rating, inter-insurance, reciprocal or reinsurance arrangement on transactions involving I-COLI contracts." "In addition," said the revenue procedure, "the IRS would welcome comments on the operation of arrangements involving I-COLI contracts."

Thoughts for the Future

Whenever information is requested by a government agency, it is incumbent upon those receiving the request—or at least those most likely expected to respond to the request—to evaluate carefully the advisability of replying along with the content of their reply. That said, it is fairly obvious from the questions being asked by the IRS in section 6 of the revenue procedure that the IRS (and the Treasury Department) is serious about examining the treatment of I-COLI under the tax law. Hence, while no reply is mandated, seemingly it would be a good idea for the holders and the sellers of I-COLI to provide one. It is unlikely that the questions will be resolved on their own or simply disappear, and if those interested in and knowledgeable of I-COLI arrangements do not respond to the request for information, there is no guarantee that the questions will be answered appropriately. The authors anticipate that a response to

one or more of the questions will be forthcoming from the ACLI, which worked successfully to have the revenue procedure issued, as well as from the Committee on Insurance Companies of the American Bar Association's Section of Taxation. It also would be proper for insurers, whether as holders or as sellers of I-COLI, to consider offering the input requested, for questions not satisfactorily answered in the short run may well appear again in the next audit cycle.

So, if the questions listed in Revenue Procedure 2007-61 are to be answered, which questions should receive the responders' main attention? First of all, it may be instructive that the request for additional information or argument on the construction of the pertinent Subchapter L rules (or section 264(f), for that matter) did not even make the list. Indeed, in its section 5, the revenue procedure recites that it will make any change in the interpretation of the Subchapter L rules prospective "[i]f, in response to comments, additional guidance is published interpreting the phrase 'contracts to which section 264(f) applies'." In other words, there may be no further guidance on the point. Diminution of any lingering concern over the interpretation of the Subchapter L rules would be consistent with, and explained by, the express view of the Bush Administration that businesses operating in one type of industry (*e.g.,* insurance companies) should not be treated any more or less favorably under the tax law than those operating in another type of industry (*e.g.,* banks). This view can be seen as the driving force behind the Treasury Department's role in the (relatively) prompt issuance of the revenue procedure following the release of the contrary private letter ruling to the ACLI. It likewise is particularly on point when the businesses involved may properly be considered to operate within the very same industry (*i.e.,* financial services). All of this said, it is possible that some continuing concern remains over the proper construction of the Subchapter L rules, as witnessed in the last sentence of section 6.01 of the revenue procedure, *i.e.*, in the statement indicating that "[i]n addition" the IRS "would welcome comments on the operation" of I-COLI. Whether or not the construction of the tax law's rules is central to the revenue procedure's information requests, the fact remains that it is

Experience rating, the first topic mentioned in the revenue procedure's list, is a widely used feature in broad-based COLI cases …

the subject of the safe harbor, and hence the arguments in favor of the more sensible reading of the applicable rules should be recorded, forcefully, in the responses to the questions.

Taking section 6.01 of the revenue procedure at face value, it is likely that the IRS and the Treasury Department are most interested in receiving comments on the first set of topics listed in that section: the effect of any experience rating, inter-insurance, reciprocal or reinsurance arrangement on I-COLI transactions. This request covers a good deal of ground, and it treads on some issues that are not simple to discuss, so that answering the request will necessitate careful planning on the part of those responding. Experience rating, the first topic mentioned in the revenue procedure's list, is a widely used feature in broad-based COLI cases, including I-COLI, and one that is based in long-standing insurance industry practice and acknowledged in the rules of the tax law. It also has attracted some attention, and controversy, by virtue of the litigation on leveraged COLI, in which the use of "100 percent experience rating" led the courts to question whether the COLI contracts involved the presence of insurance risk at all.[4] In addition, the Emerging Issues Task Force of the Financial Accounting Standards Board has raised its own questions about the effect of experience rating on COLI and other group insurance arrangements, even going so far as to propose radical changes in the GAAP accounting for such arrangements. At base, the question here is a central one to the existence of insurance, for it asks whether risk has been shifted away from the policyholder in a meaningful way under a COLI arrangement. Accordingly, any response on this topic will need to recognize and explain the authorities

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[4] American Electric Power, Inc., v. United States, 136 F. Supp. 2d 762 (S.D. Ohio 2001), *aff'd* 326 F.3d 737 (6th Cir. 2003), *cert. denied,* 540 U.S. 1104 (2004); In re C.M. Holdings, Inc., 254 B.R. 578 (D. Del. 2000), *aff'd* 301 F.3d 96 (3d Cir. 2002); Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254 (1999), *aff'd* 254 F.3d 1313 (11th Cir. 2001), *cert. denied,* 535 U.S. 986 (2002). *See also* Dow Chemical Company and Subsidiaries v. United States, 250 F. Supp. 2d 748, *modified* 278 F. Supp. 2d 844 (E.D. Mich. 2003), *rev'd* 435 F.3d 594 (6th Cir. 2006), *cert. denied,* 127 S.Ct. 1251 (2007). It should be noted that the issue in these cases was the deductibility under section 163 of interest on the COLI contract loans. The government did not directly challenge the status of the corporate-owned life insurance contracts as insurance on account of experience rating; rather, the government argued that the lack of insurance risk indicated that the COLI contract loan transactions lacked economic substance.

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to date, distinguishing the good from the questionable, and in some fashion come to grips with the difficult issue of defining when and how the shifting of insurance risk is adequate or meaningful.[5]

The remaining topics in the list—inter-insurance, reciprocal or reinsurance arrangements that have an effect on I-COLI transactions—present equally significant issues that are not simple to discuss in a response to the IRS. Interestingly, in the COLI context, this group of issues smacks of captive insurance concerns. In the litigation and ruling activity involving so-called captive insurers, for example, reinsurance played a large role in returning to the policyholder the losses from insurance risks that initially were transferred to a third-party insurer.[6] It therefore is not surprising that the IRS is raising the point again in the context of I-COLI, as it continues to do in circumstances involving captive insurance arrangements even though it abandoned its earlier "economic family" approach to the captive issue. Reminiscent of the IRS's current approach in the captive insurance area, the safe harbor rule in section 4 of the revenue procedure recites that I-COLI contracts will "remain subject to challenge under other provisions of the tax law, including judicial doctrines such as the business purpose doctrine." [7]

For now, however, it seems that the revenue procedure has granted insurance companies a large measure of comfort that the I-COLI they are holding, covering only insureds in the permitted classes under section 264(f)(4)(A) and hopefully fitting within the revenue procedure's 35 percent limit, does not diminish their otherwise allowable reserve deductions. Today, in the context of GAAP guidance such as FIN 48, requiring a "more likely than not" conclusion that claimed tax benefits will be realized before they can be recognized for financial accounting purposes, such comfort clearly is needed. On the other hand, issues associated with I-COLI cannot be viewed as having been put to rest. The insurance industry may therefore find it beneficial to take this opportunity to respond to the IRS's request for comments in section 6 of the revenue procedure.

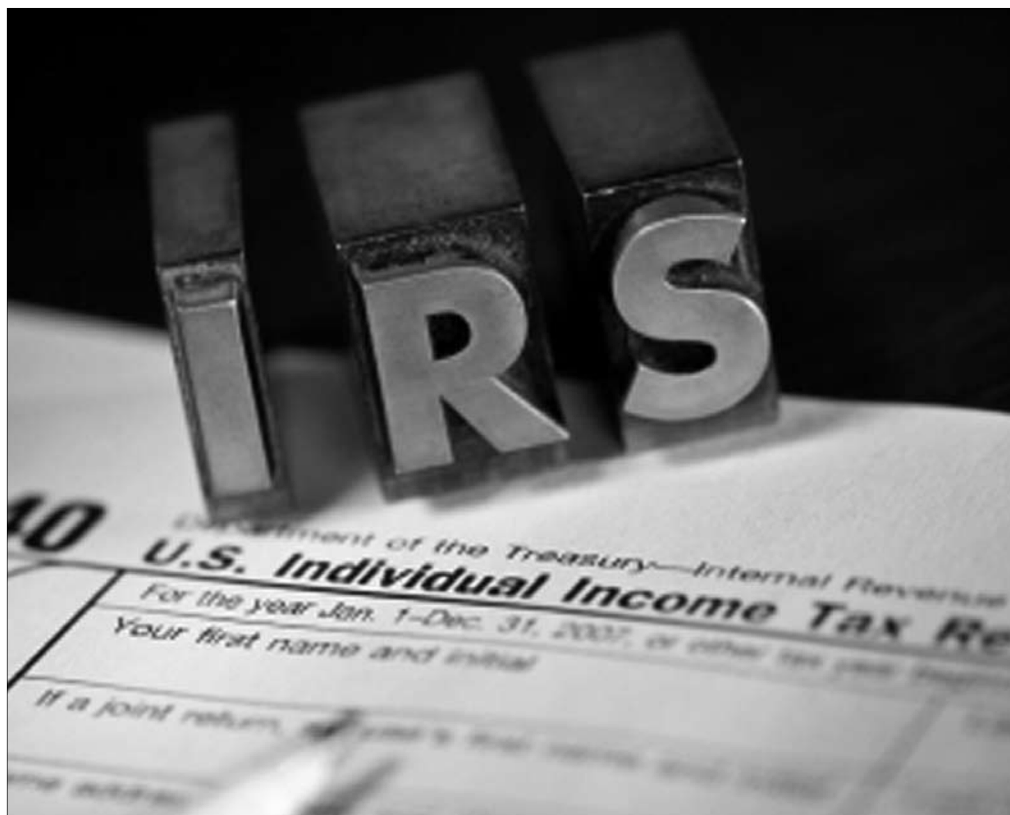
[5] *See* Kirk Van Brunt, *Experience Rating, Helvering vs. Le Gierse, and COLI/BOLI Arrangements, Taxing Times*, Vol. 1, Issue 3, at 19 (Dec. 2005).

[6] *See* Rev. Rul. 77-316, 1977-2 C.B. 53, *obsoleted by* Rev. Rul. 2001-31, 2001-1 C.B. 1348.

[7] *See* Rev. Rul. 2001-31, *supra* note 6.

Proration for Segregated Asset Accounts—Part Two

by Susan J. Hotine



Although my article "Proration for Segregated Asset Accounts—How Is the Company's Share Computed?" in *Taxing Times* (September 2007) is very recent, already two rulings have been issued that require additional comments. Just before my article went to press, the Internal Revenue Service (IRS) issued Rev. Rul. 2007-54, 2007-38 I.R.B. 604, stating that: (i) Under I.R.C. § 807(d)(1), the amount of the year-end life insurance reserves for a contract in two situations was the amount of the tax reserves determined under I.R.C. § 807(d)(2); and (ii) in both situations, because the reserves determined under I.R.C. § 807(d)(2) for the contract used the applicable Federal interest rate (AFIR) and exceeded the net surrender value of the contract, the required interest on the contract's life insurance reserves was calculated by multiplying the mean of the contract's beginning-of-year and end-of-year reserves by the AFIR for the contract. Then, the IRS issued Rev. Rul. 2007-61, 2007-42 I.R.B. 799, suspending Rev. Rul. 2007-54 and informing taxpayers that Treasury and the IRS intend to address in regulations the issues considered in Rev. Rul. 2007-54. The suspension was in response to industry arguments that the provisions on which Rev. Rul. 2007-54 is based carried over from the 1959 Act to the 1984 Act, and that the ruling should not be applied retroactively because its analysis is inconsistent with certain authorities under the 1959 Act. This article discusses the two rulings.

There are many reasons why the position taken in Rev. Rul. 2007-54 is wrong regarding how required interest for variable contract reserves should be computed. First, as the analysis of the Code and the relevant legislative history set forth in my earlier article indicates, the position does not follow the guidance of prior law. Second, the position seems to be based on false assumptions—that proration for a contract is based on a single reserve computed for the contract and/or that all federally prescribed reserves under I.R.C. § 807(d)(2) are computed using the higher of the AFIR or the prevailing State assumed interest rate (PSAIR). Rev. Rul. 2007-54 acknowledges that certain variable reserves are accounted for as part of the general account and others as part of the segregated asset account under I.R.C. § 817(d), and says that the general account and segregated asset account reserves for variable contracts are combined to determine the amount of the life insurance reserves taken into account under I.R.C. § 807(c)(1). *See* I.R.C. § 807(d)(1). However, the ruling then seems to assume incorrectly that there is a single I.R.C. § 807(d)(2) reserve computation for all the benefits under the contract. This single reserve assumption leads the IRS to the incorrect conclusion that the AFIR (or the higher of the AFIR or the PSAIR) is the only relevant interest rate for purposes of computing required interest.

Consider the example of a fixed-benefit life insurance contract with a waiver of premium supplemental benefit

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for which there is no separately stated charges. The basic life insurance benefit reserve for the contract might be computed under I.R.C. § 807(d)(2) using the AFIR, but the life insurance reserve for the waiver of premium benefit is the statutory reserve, with no requirement that the assumed rate of interest must be the higher of the AFIR or PSAIR. Assuming that the aggregate of these two reserves exceeds the net surrender value for the contract, required interest would be computed for each of the reserves using the interest rate assumed in computing the reserve—using the higher of the AFIR or PSAIR for the basic life insurance reserve and using the rate of interest assumed in computing the statutory reserve for the waiver of premium benefit (as the appropriate rate). This example illustrates that the Code recognizes separate reserves for separate benefits and requires a separate proration calculation for each reserve. The fact that I.R.C. § 817(d) specifically sets forth different treatment for different benefit reserves under a variable contract should be read as likewise directing separate proration calculations for the separate reserves computed for guaranteed and non-guaranteed benefits under a variable contract.

The legislative history explaining I.R.C. § 817(c) specifically refers to a separate proration calculation for variable contract reserves based on segregated asset accounts.

Third, the position taken in Rev. Rul. 2007-54 fails to recognize the adjustments to reserves required for variable contracts. I.R.C. § 817(a) provides specific rules that require the company to adjust the end-of-year I.R.C. § 807(c)(1) reserves down or up for purposes of determining whether there is an increase or decrease in reserves for the year. Because I.R.C. § 817(a) alters how contract reserves based on segregated asset accounts are taken into account by the company, I.R.C. § 817(c) requires separate accounting for the various other items related to contracts based on segregated asset accounts. The required reserve adjustments under I.R.C. § 817(a) change the amount of the company's increase or decrease in reserves for the year and, so, income and deduction items related to the contract's reserves should reflect such change through separate accounting. The legislative history explaining I.R.C. § 817(c) specifically refers to a separate proration calculation for variable contract reserves based on segregated asset accounts. *See* H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1420 (1984); S. Prt. Rep. No. 169 (Vol.I), 98th Cong., 2d Sess. 546 (1984). Rev. Rul. 2007-54 fails to recognize the effect of the end-of-year reserve adjustment and the need for separate accounting.

Fourth, the position taken in Rev. Rul. 2007-54 fails the practical test of serving the purpose it ostensibly sets forth for itself. The ruling states that proration of tax-exempt interest and any dividends-received deduction is "[t]o prevent a life insurance company from realizing a double benefit for tax-preferred investment income (tax-exempt interest and dividends qualifying for the dividends received deduction) used to fund the company's obligations to policyholders." This same purpose is echoed in Rev. Rul. 2007-61 as a goal: "The Treasury Department and the Internal Revenue Service (IRS) believe it is important that the company's share and the policyholders' share of net investment income be determined in a manner that effectively prevents the double benefit that otherwise would result from the use of tax favored investment income (such as dividends qualifying for the dividends received deduction) to fund the company's obligations to policyholders." Citing the basic definition of required interest (which Rev. Rul. 2007-54 derives from regulations under prior law), the Rev. Rul. 2007-54 position would calculate required interest by multiplying the mean of the reserves by the rate of interest assumed in computing the reserves. For a fixed level benefit contract, for which the reserves increase each year until the contract terminates, the basic definition of required interest measures the amount of the increase in reserves for the year—that is, the amount of the potential double benefit to be realized by the company.

However, measuring required interest by multiplying the mean of the reserves by the rate assumed for a federally prescribed reserve computation does not measure the amount of the potential double benefit for a non-guaranteed benefit reserve of a variable contract, for which the reserve can increase, but also decrease, because it reflects both the market value and investment earnings of the assets in the segregated asset account. The absurdity of the mis-measurement is highlighted if the company is required to adjust end-of-year reserves for appreciation in assets under I.R.C. § 817(a), which effectively denies the company an increase in reserve deduction for such amount and, thus, denies the compa-

ny the potential for any double benefit for that amount. The example in Rev. Rul. 2007-54 is overly simplistic and does not include facts regarding the investment earnings that drive the changes in the variable contract's reserves. By focusing on the example, Rev. Rul. 2007-54 fails to recognize the other factors that come into play in the tax treatment of such reserves, and thus fails to appropriately measure the amount of the potential double benefit that the company can realize through deductions for such reserves. By contrast to the position in Rev. Rul. 2007-54, the formula that was used under prior law for determining the rate for required interest for variable contract reserves does take into account the end-of-year reserve adjustments required by I.R.C. § 817(a) by looking to the actual investment earnings of a segregated asset account that are available for crediting to the contract reserves.

These are just a few of the substantive problems with the conclusions in Rev. Rul. 2007-54. The life insurance industry will have the opportunity to point out more to the Treasury Department and the IRS. It must be acknowledged that, in suspending Rev. Rul. 2007-54, Rev. Rul. 2007-61 did not say that the position taken in the earlier ruling was incorrect. However, by suspending the ruling, the Treasury and the IRS at least must have concluded that the position set forth in Rev. Rul. 2007-54 was a significant enough change from prior guidance that a revenue ruling was not the appropriate vehicle, that it required implementation through regulations. The regulatory process, with notice and the opportunity for comments, presumably is intended to give the proration issues for segregated asset accounts a full and fair hearing. In the end, regulations could be adopted that are consistent with the industry's position of following guidance from the 1959 Act, or that are consistent with the position taken in Rev. Rul. 2007-54, or somewhere in between. It should be noted that, under a 1996 amendment to I.R.C. § 7805(b), any proposed, temporary or final regulation must be prospective, with certain limited exceptions. Likewise, prior to 1996, retroactivity of regulations depended on whether the regulations changed settled prior law on which taxpayers justifiably relied, the extent to which prior law had been implicitly affirmed by Congress, and whether retroactivity might cause inequality of treatment among taxpayers and be inappropriately harsh. *See Klamath Strategic Investment Fund LLC v. United States,* 440 F. Supp. 2d 608 (E.D. Tex. 2006). Although Rev. Rul. 2007-61 states that a regulations project to address the issues considered in Rev. Rul. 2007-54 and provide guidance for determining required interest if neither the AFIR or the PSAIR are used has been added to the 2007-2008 Priority Guidance Plan, no formal notice has been issued regarding the actual opening of the regulations project. Rev. Rul. 2007-61 states: "Until such time, the issues should be analyzed as though Rev. Rul. 2007-54 had not been issued." If a regulation that adopts the position of Rev. Rul. 2007-54 (or any other position that is a substantial departure from prior-law guidance) will only have prospective effect, the IRS may be in a practical quandary regarding what administrative position to take in audits prior to such regulation being released.

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Calculation of Tax Expense in a Principles-Based Reserves Environment

by Edward L. Robbins

It appears that one of the major questions of the Principles Based Reserves (PBR) era is, "If it is accepted that reserves should be pre-tax, why should required capital be post-tax?" This article attempts to resolve that issue.

First, let's examine why statutory reserves should be pre-tax, and why that issue is related to the need to fully admit deferred tax assets (DTAs) and liabilities (DTLs) on the statutory balance sheet to accomplish "system integrity."[1] Assume a 35 percent tax rate.

Definitions

$R(s)_z$ Statutory reserve, end of year z, pre-tax.

$R(t)_z$ Tax basis reserve, end of year z.

ACF_z Actual pre-tax cash flows during year z, *i.e.,* premiums, benefits, expenses, excluding interest earned (i) on prior year reserve

ECF_z Expected pre-tax cash flows, year z, excluding interest earned on prior year reserve.

The DTA with respect to this item is thus equal to $(.35)*[R(s)_z - R(t)_z]$ at end of year z, assuming full admissibility.

Statutory after-tax book profit (SP_z) can then be seen, given a fully taxable organization as:

Formula	**Explanation**
$SP_z = .65*ACF_z$	(Actual cash flows net of taxes thereon)
$- [R(s)_z - R(s)_{z-1}] + .35 * [R(t)_z - R(t)_{z-1}]$	(Minus increase in reserves net of taxes thereon)
$+ .35*[R(s)_z - R(t)_z] - .35 * [R(s)_{z-1} - R(t)_{z-1}]$	(Plus increase in DTAs)
$+ .65*(i)* R(s)_{z-1}$	(Plus post-tax interest earned on prior reserve)

Thus $SP_z = (.65)*ACF_z - (.65)*[R(s)_z - R(s)_{z-1}] + .65*i* R(s)_{z-1}$ (1)

But $R(s)_z - R(s)_{z-1} + i* R(s)_{z-1}$ = The dollar-for-dollar offset to ECF_z. (Thus, for example, this number is positive if ECF is negative.) Thus $[R(s)_{z-1} - R(s)_z] = - ECF_z - i* R(s)_{z-1}$.

Substituting into formula (1), $SP_z = (.65)*ACF_z + (.65)*[- ECF_z - i* R(s)_{z-1}] + .65*i* R(s)_{z-1}$

$= (.65)*[ACF_z - ECF_z]$ (2)

Formula (2) can be intuitively described as 65 percent of the pre-tax emerging margin. Thus, for example if ACF = (-) 40 and ECF = (-) 60, then the post-tax emerging margin equals 13 (*i.e.,* 65 percent of 20).

This is a logical result and demonstrates that a pre-tax reserve provides an appropriate reserve for both pre-tax cash flows and taxes when there exists a fully admissible deferred tax asset. Please see the October, 2006 edition of the *Actuarial Practice Forum*[2] *(http://www.soa.org/library/journals/actuarial-practice-forum/2006/october/october-2006-detail.aspx)* for a more expansive paper on this issue, and the illogical result if the statutory reserve were to be calculated in a post-tax manner.

The reserve is exactly adequate if the present value of statutory book profits post-tax [PV(SP)] is zero.

From Formula (1) it can be seen that PV(SP) equals 65 percent of the algebraic sum of (i) and (ii), as follows:

(i) Present value of actual cash flows (PV(ACF))

(ii) $\sum (v^t)*(R(s)_{t-1}*(1+.65*i) - R(s)_t) = R(s)_0$, where $v = 1/(1+.65*i)$. Since $R(s)_0$ is pre-tax, then this reflects the pre-tax nature of the proper statutory reserve.

Thus $PV(SP) = .65*[PV(ACF) + R(s)_0]$. (3)

Now let's move to the Total Asset Requirement (TAR) issue, from which Required Capital (RC) is derived. Under "Principles-Based" concepts, $RC_z = TAR_z - R(s)_z$. Current authoritative guidance is such that RC is nondeductible under tax law but does not contribute to the company's DTA.

Define distributable earnings (DE_z): $= SP_z + RC_{z-1}*(1+.65*i) - RC_z$. (4)

As shown in the above calculation of SP_z, Formula (4) can be intuitively described as post-tax statutory book profit (SP_z) plus the releases of required capital, plus post-tax

[1] The one exception to full admissibility would be to make allowance for a significant possibility that the entity will not realize the tax benefit of the deferred tax asset. GAAP refers to the consequent reduction of a DTA as a "valuation allowance."

[2] Society of Actuaries.

interest on the prior year end required capital. The tax cash flows are fully considered in SP_z, so that Formula (4) is a true post-tax economic reflection of distributable earnings, since tax cash flows should be considered in distributable earnings and in the present value of distributable earnings [PV(DE)].

$$PV(DE) = PV(SP) \text{ plus } \sum (v^t)*(RC_{z-1}*(1+.65*i) - RC_z) \quad (5)$$

$$= PV(SP) + RC_0.$$

Put differently, given Formulas (3) and (5),

$$PV(DE) = .65 * [PV(ACF) + R(s)_0] + RC_0. \quad (6)$$

If the ACF_z values were to include adverse scenarios, such that a positive value of RC_z is necessary to generate a zero value of PV(DE) for a particular adverse post-tax result, then Formula (6) is indicative of the fact that Required Capital needs to be calculated on a post-tax basis.

Interestingly, if RC did fully contribute to the DTA (which it does not), then DE_z would equal:

$$DE_z = SP_z + RC_{z-1} * (1 + .65 * i) - RC_z + .35*(RC_z - RC_{z-1})$$

$$= SP_z + .65*(RC_{z-1} - RC_z) + RC_{z-1}*.65*i \quad (7)$$

Putting formula (1) into formula (7) this becomes:

$$= (.65)*ACF_z - (.65)*[R(s)_z - R(s)_{z-1}] + .65*i* R(s)_{z-1} - (.65)*[RC_z - RC_{z-1}] + .65*i* RC_{z-1}$$

$$= .65 * ACF_z - .65 * [\{R(s)_z + RC_z\} - \{R(s)_{z-1} + RC_{z-1}\}] + .65*i*(R(s)_{z-1} + RC_{z-1}) \quad (8)$$

It is obvious in this hypothetical case that formula (8) is analogous to formula (1), simply by substituting TAR (*i.e.,* R(s) + RC) for the statutory reserve (R(s)) alone. Thus, following the logic of formula (2), DE_z would equal 65 percent of the margin involved comparing the TAR to the actual pre-tax cash flows.

It can be seen from the above that, since ACF is a pre-tax number, if the change in [R(s) + RC] in a given financial period is exactly sufficient to provide for pre-tax excess claims in that period (*i.e.,* for distributable earnings to equal zero), then both R(s) and RC would be pre-tax numbers in this hypothetical scenario.

Thus, we now have the linkage between statutory reserving and required capital, and the reason that the former is pre-tax while the latter is post-tax, that is:

- Reserves are partly deductible, and any excess of statutory reserves over tax-basis reserves is to be taken up by the DTA.
- Required Capital is non-deductible, but does not contribute to the DTA.

Unfortunately, the current authoritative regulatory guidance does not admit the entire gross DTA; rather, as an element of statutory conservatism, it generally only admits that small portion related to temporary differences that reverse over the next 12 months from the statement date. Thus the above analysis does not reflect current regulatory constraints; what constitutes a prescribed "valuation allowance" exists equal to the non-admitted portion of the DTA. This prescribed "valuation allowance" can be far larger than true economics would dictate, since temporary differences on reserves typically take many years to reverse. PBR will be imperfect if this issue is not addressed by the NAIC in a more effective manner.

Some simplified numerical illustrations follow, assuming a 35 percent marginal tax rate and a statutory reserve that represents the present value of pre-tax negative cash flows. Those simplifications include:

- The existence of the DTA doesn't change the level of invested assets. That is, the company is not invested any less heavily because of the existence of this asset. This is mathematically consistent with reality, in that under current regulatory guidance DTAs and DTLs are not discounted at interest.
- All the negative cash flows in the table occur at the end of the year.
- Tax DAC (pursuant to Code Section 848) is ignored.

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Table 1 illustrates the fact that, if actual negative cash flows are at 90 percent of the reserve expectations, the post-tax statutory book profit will be 65 percent of the resulting emerging margin (*i.e.,* 65 percent of the 10 percent difference between actual and expected negative cash flows). Thus the table is a demonstration that the pre-tax approach to statutory reserve calculation is appropriate.

Table 1

Pattern of Emergence of Post-Tax Statutory Book Profit

Inv.Inc.Rate	5.00%
Discount Rate	0.952381
Tax/Stat Ratio	85.0%
Act/Expected Cls	90.0%

Can vary. Doesn't change final column below.

Year	Expected Pre-Tax Cash Flows*	Res, Beg.of Year Statutory Reserve	Res, Beg.of Year Tax Reserve	DTA Beg.of Yr.	Actual C.Flows	Inv.Inc. on Stat. Res	Stat Book Profit	Ratio
1	(100.00)	523.96	445.37	27.51	(90.00)	26.20	6.50	65.0%
2	(90.00)	450.16	382.64	23.63	(81.00)	22.51	5.85	65.0%
3	(81.00)	382.67	325.27	20.09	(72.90)	19.13	5.26	65.0%
4	(72.90)	320.80	272.68	16.84	(65.61)	16.04	4.74	65.0%
5	(65.61)	263.94	224.35	13.86	(59.05)	13.20	4.26	65.0%
6	(59.05)	211.53	179.80	11.11	(53.14)	10.58	3.84	65.0%
7	(53.14)	163.05	138.60	8.56	(47.83)	8.15	3.45	65.0%
8	(47.83)	118.06	100.35	6.20	(43.05)	5.90	3.11	65.0%
9	(43.05)	76.14	64.72	4.00	(38.74)	3.81	2.80	65.0%
10	(38.74)	36.90	31.36	1.94	(34.87)	1.84	2.52	65.0%

* Excluding investment income

Legend

Expected Pre-Tax Cash Flows (CF_t):	Given
Statutory Reserve, beg. of Yr (SR_t):	$(SR_{t+1} - ECF_t)/(1.05)$
Tax Reserve beg. of yr (TR_t):	$(.85)*(SR_t)$
DTA	$(.35)*(SR_t - TR_t)$
Actual Cash Flows (ACF_t)	$(.90)*(ECF_t)$
Investment Income on (SR_t):	$=.05*(SR_t)$
Statutory Book Profit post-tax (SP_t):	$65*(ACF_t) + (SR_t - SR_{t+1}) + (.35)*(TR_{t+1} - TR_t) + DTA_{t+1} - DTA_t + (.65)*(\text{Inv.Inc.on } SR_t)$
Ratio	(Stat.Bk Profit)/(10% of expected Pre-tax Cash Flow)

Table 2 takes the same assumptions, except that it assumes an extremely adverse set of values for actual negative cash flows and calculates Required Capital on an after-tax (AFIT) basis. It shows that the Required Capital calculation should be AFIT in order to arrive at a zero value of distributable earnings.

Table 2

Required Capital is Exactly Sufficient to Cover Costs Not Provided for in Reserves

Inv.Inc.Rate	5.00%
Discount Rate	0.952381
Tax/Stat Ratio	85.0%
Act/Expected Cls	150.0%

Can vary. Doesn't change final column below.

Year	Expected Pre-Tax Cash Flows (CF's)	Res, Beg.of Year Statutory Reserve	Res, Beg.of Year Tax Reserve	DTA Beg.of Yr.	Actual C.Flows	Inv.Inc. on Stat. Res	Stat Book Profit	Ratio	Required Capital Beg.of Yr.	Release of Req.Cap	Post-Tax Inv.Inc. on Req.Cap	DE
1	(100.00)	523.96	445.37	27.51	(150.00)	26.20	(32.50)	65.0%	183.17	26.55	5.95	0
2	(90.00)	450.16	382.64	23.63	(135.00)	22.51	(29.25)	65.0%	156.62	24.16	5.09	0
3	(81.00)	382.67	325.27	20.09	(121.50)	19.13	(26.33)	65.0%	132.46	22.02	4.31	0
4	(72.90)	320.80	272.68	16.84	(109.35)	16.04	(23.69)	65.0%	110.44	20.10	3.59	0
5	(65.61)	263.94	224.35	13.86	(98.42)	13.20	(21.32)	65.0%	90.34	18.39	2.94	0
6	(59.05)	211.53	179.80	11.11	(88.57)	10.58	(19.19)	65.0%	71.95	16.85	2.34	0
7	(53.14)	163.05	138.60	8.56	(79.72)	8.15	(17.27)	65.0%	55.10	15.48	1.79	0
8	(47.83)	118.06	100.35	6.20	(71.74)	5.90	(15.54)	65.0%	39.62	14.26	1.29	0
9	(43.05)	76.14	64.72	4.00	(64.57)	3.81	(13.99)	65.0%	25.36	13.17	0.82	0
10	(38.74)	36.90	31.36	1.94	(58.11)	1.84	(12.59)	65.0%	12.19	12.19	0.40	0

Legend (continuing from Table 1 legend)

Required Capital Beg.of Yr (RC_t):	$(RC_{t+1} - SP_t)/(1+.65*.05)$
Release of RC_t:	$RC_t - RC_{t+1}$
Post-Tax Inv.Inc. on RC_t:	$(.65)*(.05)*RC_t$
Distributable Earnings (DE_t):	SP_t + (Release of RC_t) + (Post-Tax Inv.Inc. on RC_t)

For those interested, there remains the following question: "What if the Required Capital value were to generate a deferred tax asset?" The answer would be that Required Capital would simply be in the nature of a non-deductible reserve. Table 3 illustrates this hypothetical situation. Note that Required Capital would then be calculated pre-tax (BFIT) once a deferred tax asset is added to the calculations, in order for distributable earnings to be zero. [We register no opinion as to whether a deferred tax asset on Required Capital would be appropriate accounting.]

Table 3

Hypothetical Result, if Required Capital Generated a DTA

Year	Additional Pre-Tax CF's	Required Capital	Additional Tax Reserve	Additional DTA	Pre-Tax Inv.Inc. on Req.Cap	Additional Distributable Earnings
1	(50.00)	261.98	0	91.69	13.10	0
2	(45.00)	225.08	0	78.78	11.25	0
3	(40.50)	191.33	0	66.97	9.57	0
4	(36.45)	160.40	0	56.14	8.02	0
5	(32.81)	131.97	0	46.19	6.60	0
6	(29.52)	105.76	0	37.02	5.29	0
7	(26.57)	81.53	0	28.53	4.08	0
8	(23.91)	59.03	0	20.66	2.95	0
9	(21.52)	38.07	0	13.32	1.90	0
10	(19.37)	18.45	0	6.46	0.92	0

continued ▸▸28

from pg. 27

Legend

Additional Pre-Tax Cash Flows ($AdCF_t$):	Actual minus Expected Cash Flows (Pre-Tax)
Required Capital (RC_t):	$(RC_{t+1} + (AdCF_t))/1.05$
Additional Tax Reserve:	None, as RC is nondeductible.
Additional DTA ($AdDTA_t$):	35% of (RC_t)
Investment income on (($ADTA_t$):	$.05*(RC_t)$
Distributable Earnings:	$(.65)*(AdCF_t)+(RC_t - RC_{t+1}) + AdDTA_{t+1} - AdDTA_t$ $+(.65)*(\text{Inv. Inc. on } RC_t)$

Note that the RC_t value would then be a pre-tax calculation. Yet the resulting zero Distributable Earnings value would fully allow for all cash flows including taxes.

Table 4 is a reconciliation of the initial required capital shown in Table 2. It shows the derivation of the negative present value of distributable earnings if there was no required capital, thus the initial capital need (*i.e.,* the Table 2, year 1 Required Capital amount of $183.17). One can see that the future "current tax" expense as well as the future "deferred tax" expense are included in the calculation.

Table 4

Reconciliation of Table 2 Required Capital for Year 1

PV(Total CF's)AFIT	$549.51	(-)	See Present Value Schedule
Beginning Stat Res (assumes Cash flows BFIT)	523.96	(+)	See Table 1.
PV(Taxes on tax reserve releases)	133.98	(-)	See Present Value Schedule
PV(DTA releases)	$23.64	(-)	See Present Value Schedule
Net Capital Need	(183.17)		

Present Value Schedule

Year	Rel TR	Cash Fl*.65	Rel DTA
1	62.73	(97.50)	3.87
2	57.37	(87.75)	3.54
3	52.59	(78.98)	3.25
4	48.33	(71.08)	2.99
5	44.55	(63.97)	2.75
6	41.20	(57.57)	2.54
7	38.24	(51.82)	2.36
8	35.64	(46.63)	2.20
9	33.35	(41.97)	2.06
10	31.36	(37.77)	1.94
NPV	$382.80	$549.51	$23.64
Tax @ 35%	$133.98		

Legend

Rel TR:	Tax reserve decrease from Table 1.
Cash Fl*.65:	Actual cash flows from Table 2, multiplied by 65 percent.
Rel DTA:	DTA decrease from Table 1.
NPV:	Net present value, at a discount rate of "65 percent of the 5 percent investment income rate."

Finally, we need to understand the equivalence of Table 2 (no DTA on Required Capital) with Table 3 (as if there existed a DTA on Required Capital). To do this, we need to compare the Required Capital from Table 2 with the "Net Capital Liability" (Required Capital less Additional Deferred Tax Asset") from Table 3. Logic would indicate that they should be equal, or that there should be a mathematical reconciliation of the difference.

Table 5 shows that there is indeed a difference between the two scenarios, but it is reconcilable. The difference is due to the fact that there are more invested assets under the hypothetical case where an Additional DTA is established (Table 3). The extra invested assets are due to the fact that there is no reduction of investment income for the existence of the Additional DTA; that is, the entire [gross] Required Capital is still being invested. Put differently, the difference is equal to the present value of the investment income due to the invested assets not being reduced for the existence of the Additional DTA. Under the current regulatory guidance for both GAAP and statutory accounting, the Additional DTA is not discounted at interest. Therefore, the existence of the additional DTA does not decrease the supporting invested assets in a given scenario, causing an increase in the gross amount of additional Required Capital and thus an increase in supporting invested assets.

Table 5

Required Capital: Reconciliation of Table 2 with Table 3

Net Capital Liability	Compare to Table 2	Difference
170.29	183.17	12.88
146.30	156.62	10.32
124.37	132.46	8.10
104.26	110.44	6.18
85.78	90.34	4.56
68.75	71.95	3.21
52.99	55.10	2.11
38.37	39.62	1.25
24.74	25.36	0.62
11.99	12.19	0.20

Legend:

Net Capital Liability: Table 3, (Required Capital) minus (Additional DTA)

Compare to Table 2: Table 2, Required Capital

Difference: Table 3, ($Difference_{t+1}$ + Additional DTA_t*(.65*.05))/(1+.65*.05)

This article and the accompanying illustrative tables have hopefully achieved two objectives.

First, it provides proof that, where deferred tax assets are calculated without undue constraints, reserves should be calculated pre-tax, while required capital should be calculated post-tax. Note: This is not a perfect world, and current constraints on deferred tax assets might be considered undue.

Second, inasmuch as required capital is merely a reserve by another name, a reconciliation has been provided which equates treatment of required capital to treatment of statutory reserves in the hypothetical case where a deferred tax asset would be calculated on such required capital.

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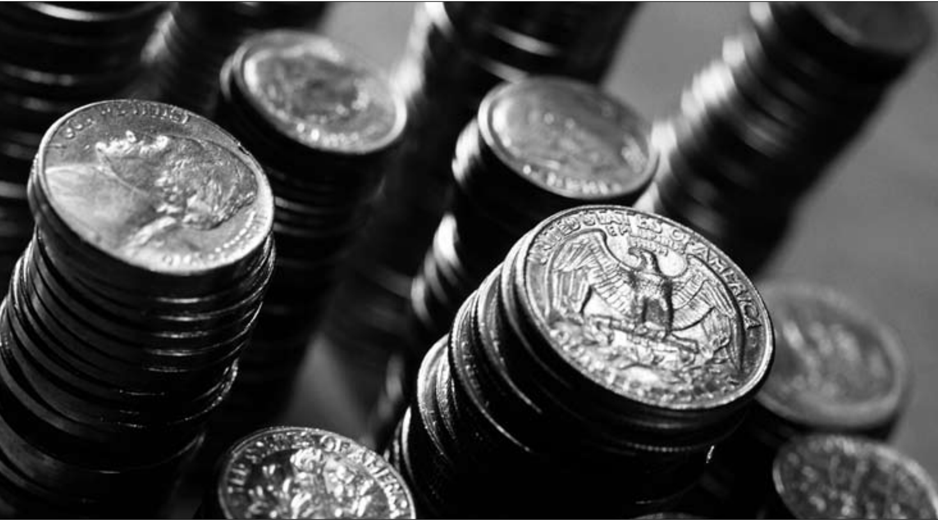
IRS to Rule on the Meaning of Statutory Reserves

by Peter H. Winslow and Samuel A. Mitchell



The Department of Treasury 2007-2008 Priority Guidance Plan dated Aug. 13, 2007 includes the following new topic under the heading "Insurance Companies and Products:"

> "Revenue ruling concerning the meaning of the term 'statutory reserves' under section 807 when the company is subject to different statutory reserve requirements in different states."

The IRS does not usually place issues with clear answers on the priority guidance plan. Therefore, we are surprised the IRS believes taxpayers need priority guidance on this topic because those in the insurance industry who have studied it generally think current law is clear and not subject to debate.

The term "statutory reserves" in I.R.C. § 807 has a well-recognized meaning under current law. "Statutory reserves" are defined in I.R.C. § 807(d)(6) as "the aggregate amount set forth in the annual statement with respect to items described in section 807(c)." The "annual statement" is defined in Treas. Reg. § 1.6012-2T(c)(5) as "the form … which is approved by the National Association of Insurance Commissioners (NAIC), which is filed by an insurance company for the year with the insurance departments of States, Territories, and the District of Columbia."[1] For purposes of determining discounted unpaid loss reserves (*see* I.R.C. § 807(c)), the annual statement is defined in I.R.C. § 846(f)(3) to mean "the annual statement approved by the National Association of Insurance Commissioners which the taxpayer is required to file with insurance regulatory authorities of a State."

When the aggregate amount of statutory reserves reported on the annual statement differs by state, Treas. Reg. § 1.801-5(a) permits the taxpayer to select the applicable annual statement to use for purposes of filing its tax return. The regulation permits the taxpayer to select the annual statement that reflects the highest aggregate reserve in any state or jurisdiction in which it transacts business. This rule has been in the regulations since the Revenue Act of 1921. *See* former Treas. Reg. §§ 39.201-4(d) and 1.803-1(d); *Pan-American Life Ins. Co. v. Commissioner,* 38 B.T.A. 1430 (1938). Treas. Reg. § 1.6012-2T(c)(1) further requires an insurance company to file with its Federal income tax return, a "copy of its annual statement which shows the reserves used by the company in computing the taxable income reported on its return."[2] This regulation suggests, consistent with Treas. Reg. § 1.801-5(a), that the applicable annual statement used for reserves is selected by the company and filed or associated with the tax return. Although the regulations permit the taxpayer to choose the annual statement for tax purposes, the taxpayer cannot pick and choose among annual statements for different purposes. Rather, the taxpayer must use the same annual statement for all reserve purposes in computing taxable income.

By its terms, Treas. Reg. § 1.801-5(a) applies specifically to the reserves taken into account to determine whether a taxpayer satisfies the 50 percent reserve test under I.R.C. § 816 for qualification as a life insurance company. Perhaps the IRS is examining this issue because some of its employees may prefer to confine Treas. Reg. § 1.801-5(a) to life insurance company qualification and desire a rule that would require taxpayers to use smaller annual statement reserves for the increase-in-reserve-deduction under I.R.C. § 807. However, this narrow interpretation of the regulation cannot be supported under current law.

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[1] The definition also includes a pro forma annual statement if the insurance company is not required to file the NAIC annual statement.

[2] An insurance company that files its tax return electronically does not transmit its annual statement with the tax return, but associates it with the return in its records for potential inspection by the IRS.

Statutory reserves reported on the annual statement affect an insurance company's taxable income in many ways. Therefore, the question of annual statement selection for purposes of the increase-in-reserves deduction must be analyzed in the broader context of how the annual statement generally is used in determining taxable income.

As stated previously, Treas. Reg. § 1.801-5(a) applies specifically for life insurance company qualification. A taxpayer qualifies as a life insurance company for Federal income tax purposes if its life insurance reserves (plus unearned premium and unpaid losses on noncancellable life, accident and health policies not included in life insurance reserves) comprise more than 50 percent of its total reserves. *See* I.R.C. § 816(a) under current law and former I.R.C. § 801(a) under the 1959 Act. Pub. L. No. 86-69 (1959). The legislative history of the 1984 Act states that I.R.C. § 816(a) adopts the same definitions as in pre-1984 Act law for both life insurance and total reserves. *See* Staff of the Joint Comm. on Tax'n, *General Explanation of the Revenue Provisions of the Deficit Reduction Act* of 1984, 98th Cong., 2d Sess. 583-584 ("1984 Blue Book"). This is consistent with the more general statements in the legislative history to the effect that where the 1984 Act incorporates and carries over provisions from pre-1984 law, Congress intended that the 1984 Act be interpreted in a manner consistent with pre-1984 "regulations, rulings, and case law." *Id.* at 581. Under the 1959 Act, as well as the 1984 Act, life insurance company qualification is determined by statutory reserves. Therefore, there is no question that Treas. Reg. § 1.801-(a) continues to apply for that purpose.

The IRS appears to be focusing on whether Treas. Reg. § 1.801-5(a) has any application for computing the amount of the deduction for life insurance reserves under I.R.C. § 807(d). Statutory reserves enter into the computation of the reserve deduction in several ways. First, life insurance reserves are computed as the higher of the federally prescribed reserve or the net surrender value of the contract, subject to an overall cap based on statutory reserves. Second, although taxpayers generally must compute federally prescribed reserves using CRVM or CARVM as prescribed by the NAIC in effect on the date of the issuance of the contract regardless of statutory reserve methods or assumptions, the legislative history provides that in computing the federally prescribed reserves for assumptions not prescribed by I.R.C. § 807(d) the taxpayer "should begin with its statutory or annual statement reserve, and modify that reserve to take into account [the adjustments prescribed by the Code]." *Id.* at 599. Third, there are several types of life insurance reserves for which statutory reserves are not required to be recomputed at all under I.R.C. § 807(d).

Therefore, as with total reserves, mutual life insurance companies were permitted by Treas. Reg. § 1.801-5(a), but not required, to choose the annual statement that yielded the highest reserve to determine statutory reserves.

As indicated earlier, the amount of life insurance reserves taken into account in the deduction for the increase in reserves is capped at the amount of "statutory reserves." "Statutory reserves" currently are defined for this purpose in exactly the same way as in repealed I.R.C. § 809(b)(4)(B). Prior to its repeal effective for taxable years beginning after 2004, I.R.C. § 809 required mutual life insurance companies to reduce certain deductions based on a "differential earnings amount." In computing the differential earnings amount, the provision required mutual company taxpayers to take into account the excess of their "statutory reserves" over their "tax reserves." For this purpose, former I.R.C. § 809(b)(4)(B) defined "statutory reserves" as "the aggregate amount set forth in the annual statement with respect to the items described in section 807(c)." The items described in I.R.C. § 807(c) are the same items included in total reserves under I.R.C. § 816(a). *E.g.,* Treas. Reg. § 1.810-2(b)(2). Therefore, as with total reserves, mutual life insurance companies were permitted by Treas. Reg. § 1.801-5(a), but not required, to choose the annual statement that yielded the highest reserve to determine statutory reserves.

An example of life insurance reserves that do not have to be recomputed under I.R.C. § 807(d) involves certain reserves for supplemental benefits. I.R.C. § 807(e)(3) provides that the amount of the life insurance reserves for certain enumerated supplemental benefits shall be the reserves taken into account for purposes of the annual statement approved by the NAIC. The legislative history equates these reserves with "statutory reserves," which presumably are the same reserves taken into account for life company qualification purposes under

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I.R.C. § 816. S. Prt. 98-169, 98th Cong., 2d Sess., Vol. I (1984); 1984 Blue Book at 604.

Statutory reserves also come into play for tax reserves other than life insurance reserves. Prior to the 1984 Act, former I.R.C. § 810(c) provided a list of reserves that were taken into account in the deduction for increases in reserves. These reserve items essentially were the same items now included in total insurance reserves required by law under current I.R.C. § 816(a). In the 1984 Act, Congress made changes to only three of the I.R.C. § 810(c) reserve items. The changes were: (1) most life insurance reserves were required to be computed in accordance with I.R.C. § 807(d)(2); (2) I.R.C. § 807(c)(3) items were required to be discounted using the higher of the prevailing State assumed interest rate or the interest rate assumed by the company in determining the guaranteed benefits;[3] and (3) I.R.C. § 807(c)(6) special contingency reserves were required to be reasonable. For all other reserves, Congress intended pre-1984 Act rules to apply without change (presumably including the definition of statutory reserves used for purposes of "capping" the life insurance reserve deduction under the flush language of I.R.C. § 807(d)(1)). 1984 Blue Book at 598. That is, a life insurance company's reserve deduction for these other reserves is determined on the basis of statutory reserves as reported in the annual statement. In 1986, the Code was amended by adding I.R.C. § 846 to require discounting of unpaid losses. *See* I.R.C. § 807(c). Discounted unpaid losses are defined in I.R.C. § 846(b)(1) to mean "the unpaid losses shown in the annual statement filed by the taxpayer for the year ending with or within the taxable year of the taxpayer."

Thus, it seems clear from the face of the statute and current regulations that the permission to use the annual statement with the highest aggregate reserve granted by Treas. Reg. § 1.801-5(a) applies both for purposes of life insurance company qualification as well as for purposes of determining the deduction for all of these reserves. Under the 1959 Act, for example, former I.R.C. § 810(c), which detailed the items taken into account for the life insurance reserve deduction, cross-referenced the life insurance reserve definition in former I.R.C. § 801 for insurance company qualification. Furthermore, the amount of unpaid losses was the same amount included in total reserves, which, under Treas. Reg. § 1.801-5(a), can be the annual statement that yields the highest deduction. *See* Treas. Reg. § 1.810-2(b)(2). When Congress added I.R.C. § 846 to the Code (with a conforming amendment to I.R.C. § 807(c)) to require discounting of certain unpaid loss reserves, it continued to determine the deduction for I.R.C. § 807(c)(2) reserve items by reference to the annual statement. *See* I.R.C. §§ 846(b)(1) and (f)(3).

In analyzing the meaning of the term statutory reserves, the IRS also must consider how its ruling will affect other types of insurance companies. Under I.R.C. §§ 832 and 846, non-life insurance companies must compute their gross income and loss reserve deductions on the basis of the underwriting and investment exhibits of the annual statement approved by the NAIC. Treas. Reg. §§ 1.832-4 and 1.846-1. Aspects of the alternative tax on small non-life companies also are determined by reference to the annual statement. *E.g.*, I.R.C. §§ 834(c)(2), (d)(2) and (e)(2). The case law under the 1959 Act and earlier law made it clear that the rule of Treas. Reg. § 1.801-5(a) applies to all types of reserve deductions and for all types of insurance companies. *Central National Life Ins. Co. v. United States,* 574 F.2d 1067 (Ct. Cl. 1978); *Pan-American Life Ins. Co., supra; Lamana, Panno, Fallo v. Commissioner,* BTA Memo 1938-182; *see* also PLR 8951001 (Aug. 29, 1989). In fact, the IRS has ruled that the annual statement with the highest aggregate reserve is required to be used for purposes of determining minimum effectively connected net investment income of a foreign insurance company carrying on an insurance business in the United States. *See* Notice 89-96, sec. II.A.(1)(c), 1989-2 C.B. 417.

The court in *Continental Ins. Co. v. United States,* 474 F.2d 661 (Ct. Cl. 1973), explained the rationale for why the rule permitting the taxpayer to select the annual statement with the highest aggregate reserve applies to all types of insurance companies. State insurance departments are concerned with ensuring solvency and this necessarily requires an examination of the company's operations in all states. The court in *Continental* noted that the reserve provisions for life insurance companies in what is now Treas. Reg. § 1.801-5(a), and the reserve provisions for property/casualty-type unpaid losses, are "quite similar." The court noted: "Both affect the measure of income, both rely on state law, both refer to the

[3] I.R.C. § 807(c) was later amended to require discounting using the applicable Federal interest rate, if it is higher than the other two rates.

requirements of 'any state' in which the company does business, and both look to the most conservative state rule." *Id.* at 669.

At a recent tax conference, IRS representatives stated that Treas. Reg. § 1.801-5(a) may no longer be applicable under the 1984 Act because permitting the taxpayer to select the annual statement with the highest aggregate tax reserves would be incompatible with Congress' desire in the 1984 Act to limit tax reserves deductions. But, this reflects a misreading of Congressional intent. The legislative history of the 1984 Act indicates that the federally prescribed reserve computation in I.R.C. § 807 is designed generally to allow a tax reserve at the minimum amount a majority of states would require to be set aside. 1984 Blue Book at 599. Thus, the calculation of the federally prescribed reserve keys off CRVM and CARVM, which specify the minimum reserve for a contract under the Standard Valuation Law. But, contrary to the IRS representatives' assumption, the primary goal of Congress in enacting I.R.C. § 807 was to convert tax reserves from net level reserves as under the 1959 Act to preliminary term reserves (CRVM) and, in doing so, place all companies on a level playing field with respect to the calculation of their federally prescribed reserves. It was not Congress' intent to require companies to compute tax reserves using the smallest possible reserve amounts. In fact, it was not until 1987 that Congress required tax reserves to be recomputed by using the applicable Federal interest rate. Pub. L. No. 100-203, Sec. 10241(a). To avoid state-by-state variation, I.R.C. § 807(d) requires reserve computations "based on the general guidelines recommended by the National Association of Insurance Commissioners (NAIC) and adopted by a majority of states." 1984 Blue Book at 599. The standard is driven by the minimum amount that "most states" would require. However, some companies may operate in states where the statutory reserves exceed the federally prescribed reserves and others in states where the minimum reserve is less than the federally prescribed reserve. This provides a "level playing field" for all companies because those companies in states where the minimum statutory reserve is less than the NAIC standard can, if they are willing to bear the economic effect on their surplus, obtain the same tax treatment as others by increasing their statutory reserves. Otherwise, they are limited by the statutory reserve cap in section I.R.C. § 807(d)(1)(B).

It was not Congress' intent to require companies to compute tax reserve using the smallest possible reserve.

The federally prescribed reserve must be distinguished from the determination of the statutory reserve cap. The statutory reserve cap is in place to ensure that an insurance company does not take a deduction for a federally prescribed reserve unless it actually holds that reserve for statutory purposes. The 1984 Blue Book explains that "the amount of the deduction allowable or income includible in any tax year [by changes in reserves] is prescribed [by the federally prescribed reserve] regardless of the method employed in computing State statutory reserves." 1984 Blue Book at 598. The latter method, the statutory reserve method, merely defines a cap on the federally prescribed reserve so that companies are not allowed deductions for reserve amounts not reflected on their financial statements. The rule that permits the taxpayer to select the annual statement with the highest aggregate reserve appropriately implements the legislative purpose because it permits all insurance companies the same CRVM or CARVM reserve deduction unless their statutory surplus is not impacted by the reserves.

In summary, it appears that current law already answers the question posed in the Treasury Priority Guidance Plan. Statutory reserves should be those reserves reported on the annual statement selected by the company. We will have to wait and see whether the IRS agrees.

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Proposed Regulations Would Deny Reserve Deductions for Certain Captives

by Rick Gelfond and Yvonne S. Fujimoto

On Sept. 27, 2007, the Internal Revenue Service (IRS) and the Treasury Department (Treasury) issued proposed regulations under Internal Revenue Code (Code) section 1502 related to consolidated group intercompany insurance transactions. The proposed rules would technically still require certain domestic captive insurance companies to be taxed under subchapter L of the Code, but would effectively take away their current deductions for loss reserves and unearned premium reserves. The proposed regulations affect captive insurance companies who are members of consolidated groups and insure the risks of their fellow members. This rule would not apply to captive insurance companies whose members' insurance premiums are less than five percent of all insurance premiums written during the taxable year. In addition, the proposed regulations do not appear to apply with respect to nonmember underwriting risks.

This release was unexpected given the case law and other more recent pronouncements by the IRS and Treasury respecting captive insurance arrangements that would now seem to fall within the guidelines of these proposed regulations. It is also interesting that the attack on captive arrangements has come by way of the regulations on intercompany transactions rather than a direct attack on captives themselves. Taxpayers currently with captive insurance arrangements should remember, however, that these regulations are only PROPOSED and, as a result, do not have the authority of temporary or final regulations.

These proposed regulations would apply to intercompany insurance transactions occurring in consolidated return years beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. The official period for comments and requests for a public hearing ended on Dec. 27, 2007.

The Proposed Regulations

The proposed regulations impose single entity treatment on insurance and reinsurance transactions "where a significant amount of the insuring member's business arises from transactions with other group members." The captive insurance company would be considered a "significant insurance member," defined under proposed Treasury regulation section 1.1502-13(e)(2)(ii)(C)(2)(i), "if it is an insurance company subject to tax under subchapter L and five percent or more of the member's insurance premiums written during the taxable year arise from insuring risks of other [brother-sister] members of the group."

By imposing single entity treatment, the insurance arrangement between the significant insurance member and the other members of the group would be treated as "self-insurance" by a single corporation.

Pursuant to proposed Treasury regulation section 1.1502-13(e)(2)(ii)(C)(1):

> [T]he timing and attributes of items from a premium payment from an insured member to a significant insurance member will be taken into account under the matching and acceleration rules, and the premiums earned with respect to the intercompany payment will not be accounted for by the significant insurance member under the rules of section 832(b)(4) [for premiums earned]. The significant insurance member's deduction for losses incurred with respect to the intercompany insurance will be taken into account under the rules of sections 162 and 461 (including section 1.461-2), rather than section 832(b)(5) [for losses incurred].

These proposed intercompany insurance regulations would not apply to the risks of a nonmember, even if the significant insurance member assumes all or a portion of the risk on an insurance contract written by another member with respect to risks of a nonmember. The

significant insurance member would be permitted to "increase its reserve item under section 807(c) or 832(b)(5) with respect to the premium payment" related to the nonmember risks.

Captives: A Historical Perspective

Historically, the IRS and Treasury have challenged the validity of captive insurance arrangements as true insurance, using an "economic family" argument to contend that risk shifting cannot exist. (*See e.g.*, Revenue Ruling 77-316.) Except in cases where the insurance arrangement included the parent company purchasing insurance from its captive insurer subsidiary, however, the economic family argument has been repeatedly rejected by the courts. Captive insurance arrangements generally have been respected by the courts when the transaction involved brother-sister insureds. (*See e.g.*, *Humana*[1] and its progeny.)

After a series of losses with respect to brother-sister captive cases, the IRS and Treasury explicitly abandoned an economic family argument in Revenue Ruling 2001-31. In this ruling, they acknowledged that the courts had not accepted the economic family argument and stated that the "IRS will no longer invoke the economic family theory with respect to captive insurance transactions."

In 2002, the IRS and Treasury issued Revenue Rulings 2002-89 and 2002-90 which contained various examples of valid captive insurance arrangements. The proposed intercompany insurance regulations, however, would have the effect of treating some of these otherwise valid insurance arrangements as self insurance transactions for federal income tax purposes.

The proposed regulations also reflect a change from the current regulations under section 1.1502-13(e)(2)(ii)(A) which specifically require separate entity treatment for insurance transactions between members of the same consolidated group. The preamble to the 1994 regulations address why single entity treatment, as would be required under the new proposed regulations, is not appropriate and separate entity treatment should be applied:

> Reserve accounting is permitted only for special status members, and it is inappropriate to apply some aspects of reserve accounting on a single entity basis (*e.g.*, where both parties to an intercompany transaction do not have the same special status) … [I]f a member provides insurance to another member in an intercompany transaction, the transaction is taken into account by both members on a separate entity basis.

The proposed intercompany insurance regulations, however, would have the effect of treating some of these otherwise valid insurance arrangements as self insurance transactions for federal income tax purposes.

In the new proposed regulations, the IRS and Treasury explain that their departure from the current regulations is due to the former belief that "such [intercompany insurance] transactions would not have a substantial effect on consolidated taxable income, and therefore, it was appropriate to except these transactions from single entity treatment." Later in the preamble to the proposed regulations, the IRS and Treasury state their current belief that the "increasing prevalence of captive insurance arrangements within consolidated groups," and the separate entity treatment "may now have a greater effect on consolidated taxable income than was anticipated when the Current Regulations were issued." It is not clear from the preamble, however, whether the concern was simply that more taxpayers are entering into transactions that fall within the subchapter L rules, or that such transactions will have a "greater effect on consolidated income" in any individual case.

As such, the recently proposed regulations disallow the provisions of subchapter L with respect to intercompany insurance transactions. They specifically provide that sections 162 and 461 will apply rather than section 832 to loss reserve deductions. The proposed regulations, therefore, seem to imply that sections 162 and 461and the matching and acceleration rules have not applied to captive insurance companies in the past. The fact of the matter is that sections 162 and 461 have always applied to insurance companies but Congress has specifically

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[1] *Humana Inc. v. Commissioner,* 88 T.C. 197 (1987), *aff'd in part, rev'd in part,* 881 F.2d 247 (6th Cir. 1989).

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provided that the timing of the deductibility of loss reserves is governed by subchapter L.

Another item that merits further consideration with respect to the proposed regulations relates to unearned premium reserves. For example, the proposed regulations provide that member insurers of consolidated groups lose their current deductions for unearned premium reserves.

For the typical one-year policy issued by many captive insurance companies, the deduction of the premium by the insured members of the consolidated group and the premiums earned by the captive member are matched and the question of an unearned premium reserve is moot. A situation involving a multi-year insurance policy, however, could potentially lead to some mismatch of income and deduction within a consolidated group if the insured were to take a deduction for the full premium when paid at the same time that the captive insurer includes in income only a portion of the amount received because of the limitation on the deduction of the unearned premium reserve. The IRS, however, can rely on section 263 to enforce any inappropriate mismatch of deduction and income and, in the case of reinsurance transactions, it can turn to section 845. A change to the intercompany insurance regulations is not necessary.

What Happens Next?

Approximately 10 years ago, there was a legislative proposal targeting captive insurance arrangements and the lobbying effort against it was strong. Currently, there are 26 states with captive insurance company legislation which make captives a significant revenue raiser for those states. As one would expect, a significant effort is being undertaken by the states and captive insurance industry providers this time around as well.

Should the proposed regulations be finalized in their current form, the regulation would not apply to the intercompany insurance transactions that occurred prior to the effective date. In other words, "self insurance" treatment would only apply to the premiums and loss reserves established in consolidated return years on or after the final regulations are published in the Federal Register. It is interesting that the government maintains that captive insurance companies in consolidated groups are still insurance companies for federal tax purposes even though their reserve deductions no longer exist with respect to business written on the risks of their members.

Many taxpayers with captive insurers within their consolidated groups are rightfully concerned about their arrangements. Some are considering restructuring their consolidated group while others contemplate an offshore captive. It would seem, however, that any action of this type may be premature. The proposed regulations are simply that. They are proposed. That being said, all taxpayers with captive insurance companies in their consolidated groups should pay close attention to the debate over these regulations and consider whether and how it still may be possible to participate in the discussion. ◂

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ACLI Update Column

by Bill Elwell

In accordance with the American Council of Life Insurers' (ACLI's) commitment to reserve modernization, the ACLI continues its contact with the Treasury Department and the Internal Revenue Service (hereinafter referred to collectively as Treasury) relating to the National Association of Insurance Commissioners' (NAIC's) exposure draft of *"Actuarial Guideline VACARVM – CARVM for Variable Annuities Redefined"* (AG VACARVM), and the *Requirements for Principles-Based Reserves for Life Products,* section 20 of the proposed Valuation Manual that would be adopted pursuant to a proposed change to the Standard Valuation Law (Life PBR).

Because the Treasury is responsible for interpreting federal income tax laws, the ACLI is focusing substantial efforts to ensure that: (1) Life PBR and AG VACARVM are compatible with the current federal income tax laws applicable to life insurance companies and policyholders, and (2) the Treasury understands reserve modernization.

The ACLI's ongoing outreach to the Treasury is necessary to elicit its views on the compatibility of key aspects of these reserve modernization proposals with the existing tax laws. The Treasury does not ordinarily engage in hypothetical discussions, but the ACLI was able to open a dialogue on Life PBR and AG VACARVM to encourage the Treasury to consider the current proposals and offer suggestions, if needed, that could lead to refinements to these methodologies.

The Treasury has requested that the ACLI include all parties involved in Life PBR and AG VACARVM in these discussions. The ACLI's discussions with the Treasury have included: (1) an informal meeting in September 2006; (2) a formal meeting in January 2007; and (3) a June 6, 2007 letter outlining the AG VACARVM proposal. Most recently, on Sept. 6, 2007, the ACLI and representatives from the American Academy of Actuaries (Academy), the NAIC, and the Affordable Life Insurance Alliance (ALIA) met with representatives from the Treasury to discuss AG VACARVM and, to a lesser extent, Life PBR. The ACLI approached the Treasury on AG VACARVM first because: (1) AG VACARVM may be implemented before Life PBR; (2) AG VACARVM raises fewer tax issues than Life PBR; and (3) decisions the Treasury makes on AG VACARVM could facilitate similar decisions it must make when considering the broader issues of Life PBR.

The Treasury anticipates issuing a Notice in the near future that will: (1) identify the tax issues raised by Life PBR and AG VACARVM; (2) outline potential positions that the Treasury is likely to take on Life PBR and AG VACARVM; (3) offer alternative interpretations to the tax issues raised by Life PBR and AG VACARVM; and (4) request comments or support for other interpretations.

Even with this guidance, however, the ACLI does not anticipate receiving comprehensive guidance from the Treasury until: (1) the NAIC finalizes the Life PBR and AG VACARVM proposals, or (2) the states adopt the proposals.

The ACLI would like to work closely with the Academy, the NAIC and the ALIA to respond to the anticipated Notice, and anticipates participating in additional meetings with the Treasury on these reserve modernization efforts. If necessary, the ACLI will continue to work with the Treasury in an open forum to further refine the current reserve modernization proposals to accommodate federal income tax laws. ◂

Note from the Editor: After this Update Column was written, the IRS released Notice 2008-18 (Jan. 14, 2008.) The Notice was issued to alert life insurance companies to federal income tax issues that may arise should the NAIC adopt the proposed Actuarial Guideline VACARVM (AG VACARVM) and/or a proposed principles-based approach for calculating statutory reserves for life insurance contracts (PBR). A supplemental issue of *Taxing Times,* to be distributed to Taxation Section members in late February or early March, will feature a dialogue between Christian DesRochers, Edward Robbins and Peter Winslow addressing a number of questions the IRS raised in the notice relating to the proposed Actuarial Guidelines. Comments on the notice are to be submitted in writing to the IRS by May 5, 2008.

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T³: Taxing Times Tidbits

The 2008 AFR and AFR-Recomputation Election

by Bruce D. Schobel

On Nov. 20, 2007, the Internal Revenue Service (IRS) released its table of applicable Federal interest rates (AFR) for December 2007. The mid-term annual interest rate fell by 26 basis points, from 4.39 percent for November to 4.13 percent for December. That provided the last of 60 monthly figures needed to determine the 2008 AFR, which is 4.06 percent. The 2008 AFR is higher than the 2007 AFR of 3.97 percent, the first increase in the annual AFR since 1991. (If the December 2007 monthly figure had been four basis points lower, then the 2008 AFR would be 4.05 percent, but still higher than the 2007 AFR.)

The 2008 AFR will be used to compute federally prescribed reserves for contracts issued in 2008 and—theoretically, anyway—to recompute federally prescribed reserves for any company that made the AFR-recomputation election in section 807(d)(4)(A)(ii) for contracts issued in 1993, 1998 and 2003 (for which federally prescribed reserves are currently computed using the 2003 AFR of 5.27 percent). The difference between the 2003 AFR and the 2008 AFR is sufficient (at least 50 basis points) to require another favorable recomputation—the 15th consecutive one—based on a change of 121 basis points. Unfortunately, as described below, the full effect of this large change cannot be realized. The 2008 recomputation is the fifth one to include contracts at duration 15 (issued in 1993).

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Using mainstream economic assumptions, the projected AFR for 2009 would be low enough to permit one more favorable recomputation, but just barely, and 2009 will certainly be the last recomputation for quite a while. The 2009 AFR is likely to be higher than the 2008 AFR, and the 2010 AFR is likely to be higher than the 2009 AFR. By 2010, recomputation will almost certainly not be permitted under the law because the change in the AFR from 2005 would be less than the required 50 basis points. In fact, the difference would go in the unfavorable direction anyway.

Since 2004, technical considerations have limited the impact of AFR recomputations with respect to older years of issue. The Internal Revenue Code states that federally prescribed reserves must be computed using the higher of (1) the applicable AFR or (2) the prevailing state assumed rate (PSAR, also known as the 26-State rate) in effect as of the date of issuance of the contract. It is worth noting that for most life insurance products, the 2008 AFR is now higher than the PSAR. Since 2004, the PSAR had exceeded the AFR, thus requiring the use of the PSAR in the calculation of tax reserves for these products.

While the tax law provides an AFR-recomputation election, this election does not permit the PSAR to be recomputed under any circumstances. The PSAR at issue remains in effect forever.

Historical Comparison of PSAR[1] and AFR Life Insurance Products

Issue Year	PSAR	AFR
1987	5.50%	7.20%
1988	5.50%	7.77%
1989	5.50%	8.16%
1990	5.50%	8.37%
1991	5.50%	8.42%
1992	5.50%	8.40%
1993	5.00%	8.10%
1994	5.00%	7.45%
1995	4.50%	6.99%
1996	4.50%	6.63%
1997	4.50%	6.33%
1998	4.50%	6.31%
1999	4.50%	6.30%
2000	4.50%	6.09%
2001	4.50%	6.00%
2002	4.50%	5.71%
2003	4.50%	5.27%
2004	4.50%	4.82%
2005	4.50%	4.44%
2006	4.00%	3.98%
2007	4.00%	3.97%
2008	4.00%	4.06%

[1] The PSAR is for life insurance products with guarantee durations of more than 20 years.

In 2004 for the first time, the AFR dropped below 5 percent. But the PSARs for most life insurance contracts issued in 1989, 1994 and 1999 (the 2004 recomputation years) are 5.5 percent, 5.0 percent and 4.5 percent, respectively. The recomputed AFR for those years of issue—that is, the 2004 AFR of 4.82 percent—is less than the PSARs for 1989 and 1994 (although not lower than for 1999). Because the PSARs exceed the recomputed AFR for years of issue 1989 and 1994, contracts issued in those years have their federally prescribed reserves determined using the appropriate PSAR, rather than the lower AFR. Therefore, the effect of the AFR recomputation is limited. The same thing happened for contracts issued in 1990, 1995 and 2000 with respect to the 2005 AFR, for contracts issued in 1991, 1996 and 2001 with respect to the 2006 AFR and for contracts issued in 1992, 1997 and 2002 with respect to the 2007 AFR.

The 2008 AFR is again low enough that the effect of the AFR recomputation is limited for contracts issued in 1993, 1998 and 2003.

The 2008 AFR is again low enough that the effect of the AFR recomputation is limited for contracts issued in 1993, 1998 and 2003. Federally prescribed reserves for contracts issued in those years must be computed using the applicable PSARs, not the recomputed AFR, which is lower in all cases. Note that this same effect will limit the impact of the possible future recomputation in 2009, if it occurs.

IRS's Position on Retroactivity of Actuarial Guidelines to be Tested in Court

by Peter H. Winslow

In recent audits of life insurance companies, IRS agents have taken the position that, where CRVM or CARVM statutory reserves are increased to comply with one or more of Actuarial Guidelines 33 through 39, the increase in reserves does not apply for federally prescribed reserves under I.R.C. § 807(d) to contracts issued prior to the issuance of the guideline by the National Association of Insurance Commissioners (NAIC). As a result, IRS agents have disallowed deductions for reserve strengthening claimed under I.R.C. § 807(f). On July 25, 2007, American Financial Group filed suit in the U.S. District Court for the Southern District of Ohio challenging the IRS's position. *See* Case No. 1:06CV574.

Under I.R.C. § 807(d), life insurance reserves are required to be computed in accordance with the tax reserve method (CRVM for life insurance and CARVM for annuities) prescribed by the NAIC in effect as of the issue date of the contract. After the CRVM or CARVM reserve is computed, using the federally prescribed interest rate and mortality table, the reserve is compared to the statutory reserve and the net surrender value on a contract-by-contract basis.

Where there are state-by-state variations on the interpretation of CRVM and CARVM as of the issue date, Staff of the Jt. Comm. on Tax'n, 98th Cong., 2d Sess., *General Explanation of the Revenue Provision of the Deficit Reduction Act of 1984* at 601 (Comm. Print 1984) ("1984 Blue Book") sets forth general rules. First, the taxpayer is required to use the method prescribed by the NAIC as of the date of issue of a contract, and take into account any factors recommended by the NAIC for such contracts. Presumably, the factors referred to as being taken into account are those generally addressed in model regulations or actuarial guidelines (AG) issued by the NAIC. Second, where no such factors are recommended, or for contracts issued prior to the NAIC's adoption of a guideline, taxpayers are to look to the prevailing interpretation of the Standard Valuation Law (SVL), *i.e.,* the interpretation that has been adopted by at least 26 states. The 1984 Blue Book, at 599, states that, in general, life insurance reserves are computed by starting with the assumptions made for statutory reserves and then making the adjustments required by I.R.C. § 807(d), indicating that, absent a NAIC guideline or a prevailing interpretation of the states, the tax reserve method should follow the permissible interpretation of the SVL used by the taxpayer for its statutory reserves.

In TAM 200328006 (Mar. 20, 2003), the IRS National Office adopted the position in the case of AG 33 that tax reserves for a contract issued before the effective date of a new actuarial guideline cannot take the guideline into account. The TAM ignores the fact that in the particular taxpayer's facts at least some of the reserve changes may have been permissible interpretations of CARVM prior to the adoption of AG 33. In TAM 200448046 (Aug. 30, 2004), with respect to AG 34, the IRS National Office took a similar position. *See* "IRS Requires Use of Prevailing State Minimum Reserve Standard Where

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There Is No Specific NAIC Guidance at Issue Date," *Taxing Times*, Vol. 1 Issue 2, September 2005, at 15.

The IRS's position as set forth in these TAMs is in apparent conflict with the 1984 Blue Book and TAM 200108002 (Oct. 24, 2000), which provides that annual statement assumptions should be followed where they were permissible when the contract was issued and were not contrary to NAIC guidance in a majority of states' rulings at such time. See also Edward L. Robbins and Richard N. Bush, *U.S. TAX RESERVES for LIFE INSURERS* 89-90 (2006).

The fact that a taxpayer has challenged the IRS's position on these issues may result in useful clarification of the issue. Unfortunately, the clarification may be a long time in coming because the trial in the *American Financial Group* case currently is scheduled for September 2009.

New Temporary and Proposed Regulations Issued On Information Reporting Rules for Employer Owned Life Insurance Contracts

by Lynlee C. Baker

The Treasury Department (Treasury) and the Internal Revenue Service (IRS) have issued nonsubstantive temporary (T.D. 9364) and proposed regulations (REG-115910-07) that procedurally delegate authority to the IRS to prescribe the form and manner of satisfying the information reporting requirements for employer-owned life insurance contracts under section 6039I.[1] Section 6039I generally requires applicable policyholders to file a return each year showing its total number of employees, the number of employees insured with employer-owned life insurance contracts and the total amount of insurance in force at the end of the year under these contracts, as well as other related information. In connection with these requirements, the IRS has issued Draft Form 8925, Report of Employer-Owned Life Insurance Contracts, which presumably will be finalized under the authority of the new regulations.

Section 6039I was enacted in connection with section 101(j) as part of the Pension Protection Act of 2006.[2] Section 101(j) generally requires businesses to treat proceeds from company owned life insurance contracts as income with the policyholder, excluding as a death benefit only the premiums and other amounts it paid for the contracts, except where certain requirements are satisfied. Under the proposed regulations, Treasury and the IRS requested public comment on the need for guidance under section 101(j) concerning: (1) determination of the status of insured individuals as "highly compensated employees" or "highly compensated individuals;" (2) requirements a taxpayer must meet to satisfy the notice and consent requirements of section 101(j)(4); and (3) the consequences of a section 1035 exchange of an employer owned life insurance contract.

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IRS Targets Welfare Benefit Funds Using Cash Value Life Insurance

by Lynlee C. Baker and Stephen P. Dicke

On Oct. 17, 2007, the Treasury Department (Treasury) and the Internal Revenue Service (IRS) issued guidance targeting the use of certain trust arrangements funded by cash value life insurance and sold to taxpayers as welfare benefit fund arrangements intended to provide tax-deductible employer contributions exceeding certain specified limits. (Notice 2007-83, Notice 2007-84 and Rev. Rul. 2007-65, summarized in IR-2007-170.) Treasury and the IRS state that many of these types of arrangements will be treated as "listed transactions" and that the government intends to scrutinize or challenge the purported tax treatment of all the described arrangements. If the IRS challenge is successful, significant penalties and interest may be in store for those participating in such arrangements. Moreover, such arrangements may need to be unwound, likely at a significant cost to those involved. At the very least, many of these arrangements, and substantially similar arrangements, will be subject to disclosure under the tax shelter reporting rules that must be satisfied in some cases as early as Jan. 15, 2008.

In Notice 2007-83, the IRS broadly identifies as a "listed transaction" any transaction (or substantially similar transaction) involving a welfare benefit fund (excluding

[1] All references to "sections" are to sections of the Internal Revenue Code of 1986, as amended.

[2] Pub.L. No. 109-280 (2006). For more detailed discussions of section 101(j) and section 6039I, *see* "New 'Best Practices' Rules for Corporate-Owned Life Insurance," John T. Adney and Bryan W. Keene, *Taxing Times,* February 2007, and "Section 101(j) and 1035-The IRS Issues Rulings Addressing Employer Owned Life Insurance," John T. Adney and Michelle A. Garcia, *Taxing Times,* September 2007.

certain collectively bargained arrangements) that pays the premium on certain "cash value type" life insurance policies if the employer took a deduction for contributions in amounts exceeding claims incurred, plus current administrative expenses and limited reserve amounts under I.R.C. §§ 419(c) and 419A(c), in the case of benefits other than life insurance. In the case of life insurance benefits, the transaction is "listed" if the employer took a deduction for contributions in amounts exceeding insurance premiums paid and administrative expenses incurred that are properly allocable to the "current" taxable year, excluding the premiums paid on any "cash value type" life insurance policies. (For taxable years ending prior to Nov. 5, 2007, the Notice increases the employer's deduction limit generally by the aggregate costs of insurance charged under the "cash value type" policies, limited to 1980 or 2001 CSO rate costs if such COIs were not fully reported as the employee's income or excludable under I.R.C. § 79.) In Rev. Rul. 2007-65, the IRS goes so far as to apply I.R.C. § 264(a) to deny all employer deductions for contributions to a welfare benefit fund relating to premiums on cash value life insurance policies paid by the fund, whenever the fund is directly or indirectly a beneficiary under the policy. (For any taxable year ending before Nov. 5, 2007, such a deduction is generally allowed up to the COIs reported as employee income or excludable under I.R.C. § 79 for such year.) In addition, the IRS takes the position that, to the extent the benefit provided through the fund is life insurance coverage (*i.e.,* the life benefits provided are fully insured), the employer's contributions are not deductible, because no amounts are reasonably and actuarially necessary to fund any claims incurred (but unpaid) for purposes of the account limit under I.R.C. § 419A(c)(1).

The guidance reflects the IRS's concern with arrangements that use cash value life insurance in an attempt to create deductions that exceed the corresponding amounts of income required to be reported by the employee. For example, the IRS states that it intends to challenge arrangements sometimes called "419(e) plans" or "single employer plans." These arrangements generally involve an employer contribution to a taxable or tax-exempt trust (including a voluntary employees' beneficiary association (or VEBA)), that may use the contributions to purchase only term insurance on the lives of ordinary employees, but cash value life insurance on the lives of owners or key employees that is later transferred to the owner or key employee (*e.g.*, on plan termination), all purportedly on a tax-advantaged basis.

As an initial practical matter, those transactions that are the same as or substantially similar to the transaction described in Notice 2007-83 are designated as listed transactions and subjected to the tax shelter disclosure requirements. Disclosure of the transactions may be required under several provisions including: I.R.C. § 6011, relating to tax shelter disclosure by participants generally, and I.R.C. § 6111(a), relating to disclosure of reportable transactions by material advisors. Failure to disclose participation in a listed transaction as required under I.R.C. § 6011 results in a penalty in the amount of $100,000 for a natural person, and $200,000 for all others. Failure to disclose a listed transaction by a material advisor under I.R.C. § 6111 generally results in a penalty amount of the greater of $200,000 or 50 percent of the gross income received by the material advisor that is attributable to the transaction.

Failure to disclose participation in a listed transaction as required under I.R.C. § 6011 results in a penalty in the amount of $100,000 for a natural person, and $200,000 for all others.

Under I.R.C. § 6011, for each taxable year that a taxpayer participates in the reportable transaction, the Form 8886, Reportable Transaction Disclosure Statement, must be attached to the taxpayer's return. A copy of the disclosure statement must be sent to Office of Tax Shelter Analysis (OTSA) in Washington, D.C., for the first taxable year for which the transaction is disclosed on the taxpayer's Federal income tax return. Treas. Reg. § 1.6011-4(e)(1). Generally, disclosure is required even if the transaction becomes a listed transaction after the taxpayer files its tax return but before the end of the period of limitations. Recently promulgated final regulations—generally effective for transactions entered into on or after Aug. 3, 2007—provide that the disclosure statement must be filed by such taxpayers with OTSA within 90 days after the date the transaction became listed, or a time determined by the Commissioner in published guidance identifying the transaction. Under similar provisions in prior regulations for transactions entered into

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before Aug. 3, 2007, and generally after 2002, disclosure is required as an attachment at the time of the taxpayer's next filed return. Notice 2007-83 provides that taxpayers who otherwise would be required to file a disclosure statement under Treas. Reg. § 1.6011-4(e) prior to Jan. 15, 2008 (*e.g.*, certain non-calendar-year taxpayers under prior regulations), will have until Jan. 15, 2008, to make the disclosure. The regulations also generally require each taxpayer who is required to file Form 8886 to retain a copy of all documents and other records related to the transaction that are material to an understanding of the tax treatment or tax structure of the transaction.

Under the final regulations, material advisors with respect to a reportable transaction are generally required to disclose the transaction on Form 8918, *Material Advisor Disclosure Statement,* by the last day of the month that follows the end of the calendar quarter in which the advisor became a material advisor with respect to a reportable transaction. Thus, for example, to the extent that the transaction becomes reportable in October of 2007, under the final regulations, disclosure to the IRS would be required by Jan. 31, 2008. In addition, within 60 days from the date a reportable transaction number is mailed from the IRS to the material advisor in connection with the transaction, the material advisors must provide the reportable transaction number to those for which it acted as a material advisor.

The regulations provide that a material advisor is a person that derives gross income in connection with the transaction in excess of a threshold amount, and makes or provides a tax statement to or for the benefit of a taxpayer or other material advisor (1) who is required to disclose the transaction as a listed transaction or transaction of interest (or, in the case of a taxpayer, would have been required to disclose if the transaction had become listed or a transaction of interest within the statute of limitations period); or (2) who, at the time the transaction is entered into, the potential material advisor knows is, or is reasonably expected to be, required to disclose the transaction, as a reportable transaction (other than a listed transaction or transaction of interest). However, generally, with respect to a transaction that becomes listed after the transaction is entered into, a potential material advisor does not become a material advisor until the date the transaction is identified as a listed transaction. The new material advisor rules apply to transactions with respect to which a material advisor makes a tax statement on or after Aug. 3, 2007. Similar rules apply where a material advisor makes a tax statement before Aug. 3, 2007 and after Oct. 22, 2004, in which case the applicable rules are provided in Notice 2004-80, Notice 2005-17, Notice 2005-22 and Notice 2006-6. *See also* prior regulations Treas. Reg. § 301.6112-1(c)(2) (T.D. 9046). Although the earlier notices required the filing of Form 8264, *Application for Registration of a Tax Shelter,* the IRS has now mandated the filing of Form 8918 for all filings after Oct. 31, 2007. *See* Notice 2007-85.

Moreover, other reporting provisions (and any related penalties) may apply, *e.g.*, I.R.C. § 6012, relating to list maintenance requirements, and I.R.C. § 6011(g), relating to specific requirements of disclosure for taxable entities to disclose to tax-exempt entities. Any person who is required to maintain a list under I.R.C. § 6112 that fails to make the list available to the IRS upon request within 20 business days after the date of the request, is liable for a penalty of $10,000 for each day of that failure after the 20th day, subject to a reasonable cause exception.

In conclusion, the IRS guidance targets specific abuses involving a growing number of arrangements that claim to be welfare benefit funds, but also recognizes that there are many legitimate welfare benefit funds that provide benefits, such as health insurance and life insurance, to employees and retirees. In any event, it is critical for taxpayers and their advisors to make an immediate determination as to whether they have been involved in any transaction substantially similar to any transaction described in Notice 2007-83, and the capacity in which they were involved in the context of the applicable regulations, so that related reporting requirements may be identified and satisfied on a timely basis. Taxpayers who have participated in such transactions and their advisors are also on notice that the IRS intends to scrutinize closely or challenge the purported tax treatment of these arrangements.

Prepaid Interest on a Policyholder Loan is Taxable Only When Earned—Contrary IRS Ruling is Obsolete

by Emanuel Burstein

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Revenue Ruling 58-225

In Revenue Ruling 58-225, 1958-1 C.B. 258, the Internal Revenue Service (Service) ruled that the entire prepayment of interest to a life insurance company for a policyholder loan is included in the life insurer's income in the taxable year in which the interest is received. This tax treatment differed from the accounting treatment that the life insurer applied on its books to the interest, which was to include only the portion of the interest earned in a given year. The Service reasoned that a life insurer that received the prepayment had a claim of right with respect to the entire amount received.

A taxpayer that has a "claim of right" with respect to income generally must include such amount in its gross income under the claim of right doctrine. In *North American Oil Consolidated v. Burnet,* 286 U.S. 417, 424 (1932), the Supreme Court stated,

> [i]f a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

In Chief Counsel Advice 200019041, March 3, 2000, the Service effectively declared Revenue Ruling 58-225 to be obsolete ...

Court Decisions

Several courts also have held that a life insurer must include the entire amount of prepaid interest in income in the taxable year in which the amount is received. In *Franklin Life Insurance Co. v. Commissioner,* 399 F.2d 757 (7th Cir. 1968), for example, a life insurer that issued policy loans required a policyholder/borrower to prepay interest for the policy year on a loan when the loan was made and each subsequent year on the policy anniversary date. *Id.* at 761. A policyholder could repay the policy loan at any time. Upon a repayment, the interest earned would be retained by Franklin Life but the remainder of the prepaid interest "was returned to the policyholder." *Id.* at 762. A policyholder that surrendered a contract received unearned interest as part of its cash value. If the insured died, Franklin Life retained the earned interest but included the unearned interest in the amount paid to the beneficiary.

On its books, Franklin Life included in income only the interest that it earned in a given accounting period. The Seventh Circuit concluded, however, that the claim of right doctrine applied to the prepayment for tax purposes because Franklin Life was "free to use or invest the full sum [it received] in any way it [saw] fit." *Id.* Franklin Life therefore had to include the entire amount of interest in its income in the year in which it was received.

The court also concluded that an accrual basis taxpayer, such as Franklin Life, must include amounts received although there is a possibility that such amounts could be returned in the future, under general accrual tax accounting principles. It followed tax principles applied by the Supreme Court in *Schlude v. Commissioner,* 372 U.S. 128 (1962), that an accrual method taxpayer generally must include amounts in its income when they are due and payable, in order to clearly reflect income. The First, Fourth and Ninth Circuits in *Union Mutual Life Ins. Co. v. U.S.,* 570 F.2d 382 (1st Cir. 1978), *Jefferson Standard Life Ins. Co. v. U.S.*, 408 F.2d 842 (4th Cir. 1969), cert. denied 396 U.S. 828 (1969), and *Northern Life Ins. Co. v. U.S.,* 685 F.2d 277 (9th Cir. 1982), cert. denied 439 U.S. 821 (1978), respectively, also held that life insurers had to include the entire amount of prepaid interest in income in the year in which the interest was received.

Chief Counsel Advice 200019041 and the Original Issue Discount (OID) Rules

In Chief Counsel Advice 200019041, March 3, 2000, the Service effectively declared Revenue Ruling 58-225 to be obsolete and concluded that only the amount of prepaid interest that was earned must be taken into account in a given taxable year. It responded to Treasury regulations issued in 1994 that address the tax treatment of original issue discount. The Service reasoned that a prepayment of interest decreases the issue price of the obligation under Treasury Regulation section 1.1273-2(g) and that a policyholder loan would have OID to the extent that its issue price is less than its redemption price.

Section 1272(c)(2) excludes life insurers from the application of section 1272, which addresses the amount of OID included in income in a given taxable year. A life insurer takes OID on a policyholder loan that it holds into account in a given taxable year under section 811(b)(1), which provides that "the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures and other evidences of indebtedness held by a life insurer . . . shall be determined—(A) in accordance with the method regularly employed by such company, if such method is reasonable, and (B) in all other cases, in accordance with regulations prescribed by the [Treasury] Secretary."

OID tax rules and related regulations, however, can influence whether the manner in which a life insurer treats original issue discount on its books is reasonable for purposes of determining the amount of OID earned

continued ▸▸44

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under section 811(b). Chief Counsel Advice 200019041 stated, "[i]n light of how the final OID regulations treat prepaid interest, the National Office believes that allowing insurance companies to use the constant yield-to-maturity method for accounting for prepaid interest is reasonable within the meaning of [section] 811(b)." The Chief Counsel Advice concluded that the claim of right doctrine no longer applies as a result of the impact of the OID rules, so that Revenue Ruling 58-225 is obsolete. The Service has not yet declared the ruling obsolete in a formal ruling, however.

Change of Accounting Request

A life insurer that includes in income the entire prepayment of interest on policyholder loans in the year in which the interest is received must file a Form 3115 with the Service to request a change of accounting method to include only interest earned in a given taxable year. The Service must grant the request in order for the life insurer to change its accounting method. The Service has granted numerous requests by life insurers to change their accounting method to include only prepaid interest that is earned.

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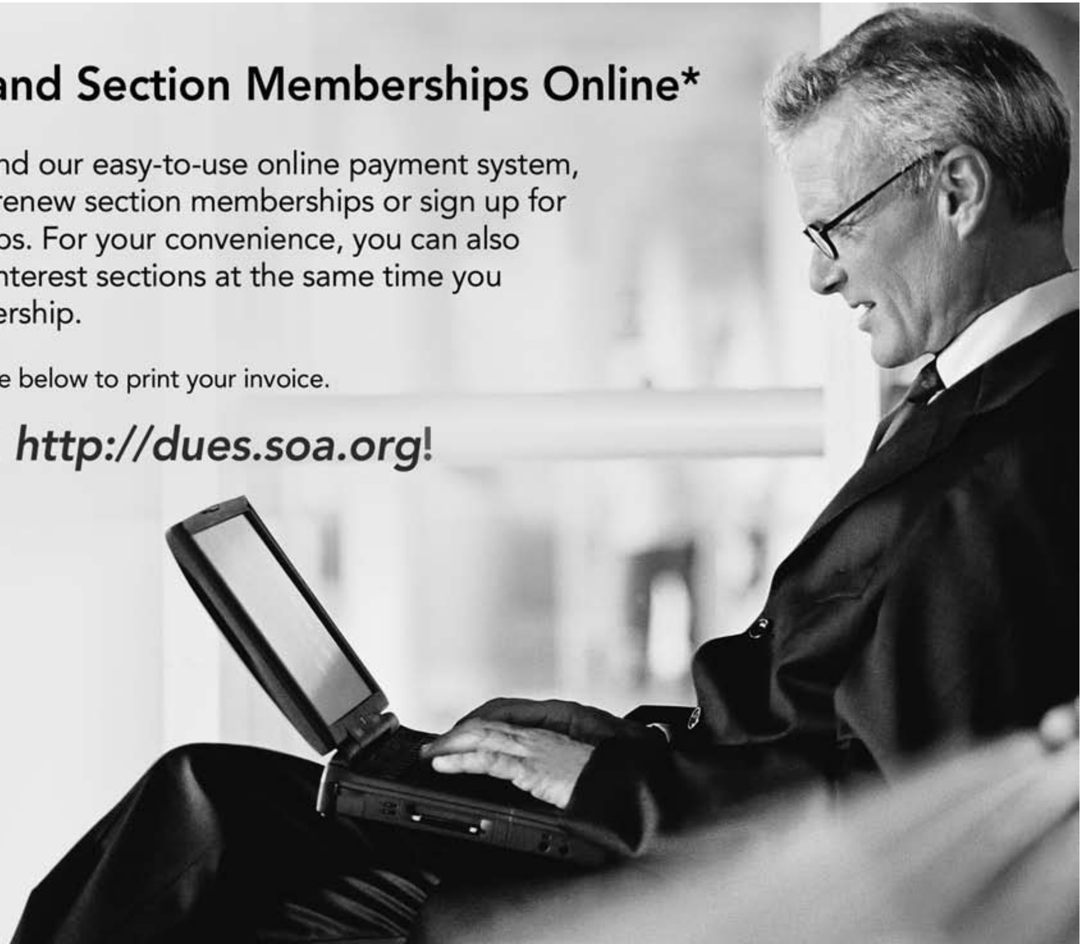

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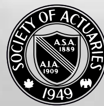
Countdown to Share Comments on CPD Requirement Begins

Hurry! Don't miss your chance to share your comments with the SOA Board on the CPD Requirement Exposure Draft. The comment period, launched in November 2007, will close on February 22, 2008. Comments and feedback from members, candidates and other interested parties received to date have helped us develop new FAQs. All feedback is critically important and will be considered at the June 2008 SOA Board meeting. Please send your questions or comments to *cpdcomments@soa.org*.

Visit *http://www.soa.org/cpd* for more information.



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