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Proration for Segregated Asset Accounts—Part Two

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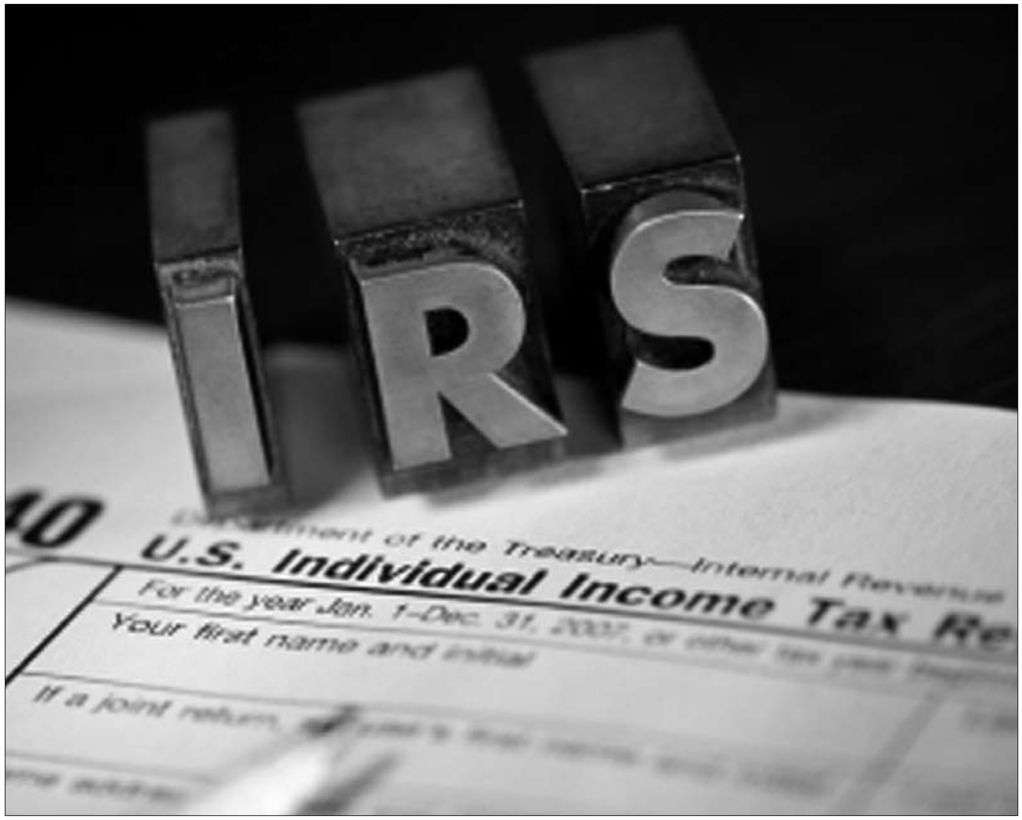

Although my article "Proration for Segregated Asset Accounts—How Is the Company's Share Computed?" in *Taxing Times* (September 2007) is very recent, already two rulings have been issued that require additional comments. Just before my article went to press, the Internal Revenue Service (IRS) issued 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 company 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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