TAXATION SECTION
"A KNOWLEDGE COMMUNITY FOR THE SOCIETY OF ACTUARIES"
VOL. 4 ISSUE 2
MAY 2008

TAXING TIMES

Getting to Know Walter Welsh

The life insurance industry is currently facing significant tax challenges (e.g., Principle-Based Reserves or PBR, Dividend-Received Deduction or DRD). The American Council of Life Insurers (ACLI) provides a strong voice for the industry on tax related issues. With this in mind, the Taxing Times *Editorial Board thought it would be important for the Taxation Section members to get to know the new head of the ACLI tax area, Walter Welsh. Welsh recently joined the ACLI as executive vice president, Taxes and Retirement Security. Kory J. Olsen, Taxation Section chair, caught up with the busy Welsh to talk about the ACLI, retirement issues and insurance regulation. Following is that interview.*

OLSEN: Walter, we are glad to see you in your new role at ACLI. To start out, could you provide a brief summary of your professional background?

WELSH: I've always been involved in tax issues. After law school, I was a trial attorney with the IRS Office of Chief Counsel in New York. In this role I was engaged in resolving disputes and litigating individual and corporate income tax cases. I returned to Connecticut to join a tax law firm specializing in business tax planning, retirement plans and estate planning. After some years, I joined Hartford as tax counsel with a concentration on resolving many ongoing company disputes with the IRS and working on the application of tax law and the development of new tax rules for new forms of life insurance products, such as universal life insurance and modified guaranteed annuities. Operations in Europe and Asia provided a steady dose of international tax issues. In recent years at Hartford, I was responsible for corporate and government relations for the life insurance company. This role contained a central focus on tax legislation and regulation. I always had some awareness of the impact of media on legislation, but this new position provided direct experience with the power of the media to influence tax legislation. A good example of this is the impact of the media stories about corporate-owned life insurance that helped generate insurance law and tax law proposals.

My educational background includes an undergraduate degree from Tufts University, a law degree from University of Connecticut School of Law (where I have been a member of the adjunct faculty teaching tax courses for a number of years) and a master's in tax law from the New York University School of Law.

OLSEN: What motivated you to leave Hartford and take on this new position at ACLI?

WELSH: I have enjoyed working with ACLI staff and participating in many of its committees on taxes and retirement issues for a number of years. In 2007, when I was planning to retire from the Hartford and devote full time to a career teaching in law school, I learned of the open position in Taxes and Retirement at ACLI. I saw it as an opportunity to continue working on tax and retirement issues, which are expected to be increasingly important in the coming years. I was also happy to have the chance to stay involved with ACLI staff and many in the industry with whom I have enjoyed working over the years.

OLSEN: You mentioned retirement and tax as growing in importance. What are some of the issues you see ahead?

WELSH: We are all aware of the growing retirement age population. Life insurers have been at the forefront of developing new forms of benefits in life insurance and annuity contracts, including new forms of long-term care riders and a whole range of living benefits for

continued 5

contents

TAXING TIMES
Vol. 4 Issue 2
May 2008

Taxation Section of the Society of Actuaries
475 N. Martingale Road, Suite 600
Schaumburg, IL 60173

- ph: 847.706.3500
- f: .847.706.3599
- www.soa.org

FROM THE EDITOR

A Call to Actuaries

BRIAN G. KING

Based on feedback from a variety of sources, *Taxing Times* has, and hopefully will continue to be, a successful newsletter. It provides our membership with timely and relevant information on the tax issues impacting our industry.

One of our founding objectives was to examine, debate and discuss tax issues in a multi-discipline environment—bringing together the "greatest tax minds" in the actuarial, accounting and legal arenas. This goal has largely been achieved. However, having said that, I am putting forward a call to the actuaries in our membership to become more involved in the writing process.

To date, a disproportionate number of the articles in each issue are generated by our members in the legal and accounting fields. Of the actuaries that do contribute, many serve on the council and/or are directly involved in the newsletter. This is not a bad thing and our content to date has been great. Personally, I feel we can produce an even better publication if we draw upon the interests and expertise of our entire membership.

So, I am putting forth a challenge to our actuarial membership to pick up your pens—or more likely, turn on your computers—and jot down your thoughts and ideas. The Taxation Section Council and the Editorial Board of *Taxing Times* are available to help you get your articles published. This help can come in the form of our peer review process. Every article published in *Taxing Times* is peer reviewed and comments and suggestions are offered to authors to modify and/or improve their articles if needed. In addition, we can help partner you with co-authors. For actuaries new to the profession or our section, teaming up with a seasoned tax veteran to co-author an article is a great way to become more involved in the advancement of our section. Many of our previously published articles are co-authored by attorneys, actuaries and accountants. I know I've posed this question before but I'll pose it again: What do you get when you combine an actuary, an accountant and an attorney? The answer is simple: A really great article for *Taxing Times* which provides a multi-disciplinary view of the tax issues challenging our industry.

So again, I challenge the actuaries among us to share your thoughts and write articles for Taxing Times. I also encourage our non-actuarial members to continue writing. Together—with contributions from all branches of our membership—we can be more effective in delivering vital information to our readership. Through our combined efforts, we will achieve our goal of taking an interdisciplinary approach to tax issues.

Thank you for your interest, volunteer efforts and article ideas. I look forward to the flood of e-mail I'm sure I'll soon be receiving!

Brian G. King, FSA, MAAA, is a managing director, Life Actuarial Services with SMART Business Advisory and Consulting and may be reached at *bking@smartgrp.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

KORY J. OLSEN

This year has been moving along quickly and the Taxation Section Council and friends of the council have been busy at work. We have been preparing for meetings and seminars, determining possible areas for tax research and gathering opportunities for you to get involved. And, of course, we continue to publish our high quality newsletter, *Taxing Times*.

Meeting and Seminars
Our spring meeting sessions are set up and ready to go, thanks to the efforts of Steve Chamberlin. The Life Spring Meeting will include three tax sessions in addition to a tax section hot breakfast. The sessions will include:

- Update—Recent Tax Guidance for Life and Annuity Insurers and Products
- Insurance Taxation in the United States and Canada—Similarities and Differences
- Long–Term Care Combination Products: Design and Implementation

We will again sponsor a session at the Health Spring Meeting. The session is titled "Update—Recent Tax Guidance for Health Insurers and Products."

The planning for the Annual Meeting and the Valuation Actuary Symposium are underway with Art Panighetti representing our section.

Our seminar team—Leslie Chapman, Barbara Gold and Brian King—has been lining up some great future seminars for our members. Be on the lookout for our involvement in the Product Development Actuary Symposium in May and ReFocus 2009 (Reinsurance). Also back by popular demand will be the Product Tax Seminar, currently scheduled for Washington D.C. in September.

Research
The Taxation Section is looking for a worthwhile research project. Some of the criteria that we are using to determine which research project to choose includes: it needs to be useful to Taxation Section members and be actuarial in nature. If you have an idea for a research project that the Taxation Section should pursue, please send it to *John Palmer at John_Palmer@ohionational.com.* Note: The idea could also include partnering with another section or entity.

Involvement
One of the reasons our section exists is to provide you with an opportunity to participate. There are many opportunities and the level of involvement is up to you. Here are some ways you can get involved:

- *Write an article for Taxing Times.* I would like to encourage more actuaries to participate in authoring *Taxing Times* articles. If you don't want to single-handedly author the article, Brian King can put you in contact with a willing co-author.

- *Basic Education.* We need volunteers to review the tax education material that is currently being used by the SOA. This can include reviewing the learning objectives, topics covered and source material and suggest changes. There are also some practice notes that need to be reviewed and updated as well.

- *Continuing Education.* Represent the section in the planning of a meeting or seminar. Or share your knowledge by speaking at one of our section-sponsored events.

- *Liaison with other groups.* Are you a member of another group where the SOA Taxation Section should be represented? The council is looking for people to act as liaisons with these other groups (*e.g.* Health Section, LTC Section, etc.).

- *Expand our presence.* The section's activities have been dominated in life insurance as that is where our volunteers have come from. The section

continued 4

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

from pg. 3

council would like to broaden our presence in other practice areas to fill a perceived non-life tax need. However, we currently do not have the expertise that is needed to fill that need. That presence could include more tax sessions at the Health Spring Meeting—either full or joint sponsorship—and other non-life seminars, more non-life tax content at the Annual Meeting, non-life research topics, non-life *Taxing Times* articles, cosponsoring other events, etc. That presence is only limited by the volunteers that we have.

- *Council Membership.* Section council elections are coming up shortly and we would like to hear from you if you are interested in being part of the SOA Taxation Council. As noted in my previous column, I would like more involvement from actuaries in practice areas other than life insurance.

These are only a few of the areas where you can get involved. There are many possibilities just waiting for you to express an interest. The level of involvement would be up to you. Please contact me at *kory.olsen@pacificlife.com* if you would like to participate.

The section council has been hard at work to support the needs of our growing section. A growing section creates more opportunities and more needs. In order to fulfill those needs and reach our full potential, we need your help.

from pg. 1

annuities. Having worked for Tom Marra, president and CEO of The Hartford, and past chairman of ACLI, I heard him frequently describe how well positioned life insurers are to provide products with a variety of guarantees to meet the needs of the expanding retiree population. These new products are great for our customers, but they present important issues for insurance regulation, and tax and retirement plan law and regulation.

OLSEN: Do you think these new products will require new federal tax legislation?

WELSH: Certainly the new products are fostering consideration of new state insurance laws and regulation for reserves, but these changes in state rules can probably be accommodated by Department of Treasury and Department of Labor regulations. The Internal Revenue Code provisions governing life insurance companies and their products were significantly refined in the mid-1980s. Those Tax Code provisions provide a framework that gives regulators sufficiently wide latitude to interpret the law to respond to new developments.

OLSEN: How do you see the role of ACLI in responding to these changes in regulation?

WELSH: ACLI, as an organization that represents almost the entire community of life insurers, can be an important force in any legislative or regulatory issue. ACLI staff brings a variety of disciplines to any issue including legal, actuarial, accounting, legislative, tax pensions, economic research and public relations. More importantly, key strengths are found in the talented staff of ACLI member companies, who make great efforts in the many ACLI initiatives.

OLSEN: What is an example of some of these challenges?

WELSH: The readers of *Taxing Times* are well aware of the issues around new NAIC rules for reserves for life insurance and annuity products (*a.k.a.* PBR). ACLI tax staff and actuarial staff are working closely together on these issues.

OLSEN: Have you had much experience working with actuaries?

WELSH: In my long experience in roles in government affairs and tax law, I always worked closely with many actuaries. I worked with Chris DesRochers, early in his career, when Hartford was one of the first issuers of universal life. The rules for reserves and taxation of universal life were unclear, and we worked together with ACLI and many in the industry on the development of tax rules that continue to govern today.

In annuity products, Hartford took the lead in developing the modified guaranteed annuities, and I worked with Craig Raymond, ACLI, and others in the industry in seeking accommodations in the nonforfeiture law and changes in tax law. In recent years, I have had the good fortune to work with and learn from Tom Campbell, who has been steadfast in his commitment to a principle-based approach to reserves. At ACLI, it is great to work with Paul Graham and John Bruins.

The actuaries have their fingers on the pulse of the life insurance business. They understand insurance risk, investment risk, product design, profitability and taxes. I've said this in other places, so it doesn't hurt to say it here—I've learned much about the life insurance business from actuaries, and I've worked with many in the industry to obtain good results on regulatory and tax issues.

OLSEN: What do you see as the most exciting challenges ahead?

I've learned much about the life insurance business from actuaries, and I've worked with many in the industry to obtain good results on regulatory and tax issues.

WELSH: The new products and new rules for reserves are causing a review of the key elements of life insurance company taxation established in the mid-1980s. Legal, actuarial and accounting professionals in the industry and the government, many of whom I have known for a long time, are working together to provide regulatory responses. I am glad to have a chance to continue to be part of this important effort. Life insurers will play an increasingly important role in helping customers meet their financial and retirement security needs. ACLI and its member companies will be at the center of the efforts to develop legislative and regulatory regimes to support that role.

continued 6

from pg. 5

OLSEN: You have mentioned the challenge of the new reserving requirements, which is definitely a major issue for the industry. What are some other, lesser known challenges you see coming?

WELSH: Certainly, another important issue is the treatment of the dividends-received deduction for insurance companies. This issue received prominence this year when the Internal Revenue Service issued a revenue ruling modifying its longstanding practice for the treatment of the dividends-received deduction with respect to dividends received on stocks held by an insurance company in a separate account. This issue has been described in detail in other issues of *Taxing Times*. We expect to participate in the resolution of this issue through the regulatory process during the course of 2008.

Our past experience shows that in times of deficits Congress has taken a close look at the taxation of insurance companies and their products. We are confident of the appropriate nature of the taxation of life insurance companies and products, but ACLI continues to work with its members to marshal our resources to respond to any tax challenges.

OLSEN: What are your long term goals for the ACLI tax function?

WELSH: At ACLI, we have the tax and retirement policy functions together. Much of retirement policy is intertwined with tax policy. The life insurance industry expects to be a significant part of the solution for retirees in the coming years. The ACLI and its Taxes and Retirement Security staff can be a catalyst for concerted industry efforts to obtain favorable tax regulation and legislation and to maintain current tax and retirement benefits, which are critical to the industry's products. Our tax and retirement staff includes three dedicated professionals—Bill Elwell, Mandana Parsazad and Jim Szostek. The strength of ACLI lies in its ability to bring together almost every life insurance company in the industry. We know that our effectiveness depends on the talents of our member companies' tax staffs and their professional advisers. The companies participate through three key committees with the following chairs for 2008: David Carlson, Hartford, Company Federal Taxation Committee; Michael Oleske, New York Life, Product Federal Taxation Committee; and James Lang, Principal Financial Group, Pension Committee. I hope that my long-term experience in the industry, with working relationships with many of the professionals, can help bring people together through ACLI to work on new and important regulatory and legislative issues.

OLSEN: Prior to arriving at ACLI, was there a particular tax issue that held your attention more than others?

WELSH: At Hartford, we were instrumental in the industry efforts to propose a lower tax rate on the income from annuity payouts for life. This proposed legislation was important because of its recognition of the importance of lifetime annuity payments and the relevance of a tax rate that takes into account the long-term nature of these annuity payments and the underlying fairness in applying a rate of tax that is similar to the tax rate of many other investments. This proposal has been supported by a coalition of groups outside the insurance industry, but budget deficits in recent years have presented a difficult challenge for any tax incentive.

OLSEN: Now that you are at the ACLI, is there a particular issue that you want to see move forward?

WELSH: At ACLI, we know that member companies continue to be interested in the proposal for tax exclusion for lifetime annuity payments. As ACLI and its members look ahead, we need to think about this incentive and other means of encouraging lifetime payments from annuities and from qualified retirement plans. Some of these approaches will have a tax component, but there may be other mechanisms to encourage the use of these important lifetime products.

On a much broader scale, life insurance companies will be taking the lead in developing new forms of products for retirees, and ACLI and its member companies need to take the lead in developing and fostering the appropriate tax posture for these products.

OLSEN: Walter, thank you for taking the time from your busy schedule for this interview and to help our readers get to know you a little better. I look forward to seeing the progress of your efforts on these topics.

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

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

On Grandfathers and Adjustments: New IRS Chief Counsel Advice Memo Blurs Lines

by John T. Adney, Bryan W. Keene and Craig R. Springfield

In general terms, a "grandfather clause" is a provision of law that creates an exemption from the law's effect for transactions that existed before the law was passed.[1] Such provisions are common in federal tax legislation, reflecting a congressional intent to avoid changing the rules of the game on taxpayers after the game has begun, as well as the practical difficulties of applying new rules to old transactions that might need to be "unwound" if the new law applied to them. Of course, Congress is not obligated to include grandfather clauses when enacting new tax legislation, and it can (and has) passed new tax laws without grandfathering prior transactions, particularly when the new law addresses a perceived abuse of the system.[2] However, in virtually all cases of new tax laws altering the federal income tax treatment of life insurance contracts, Congress has found it appropriate to include grandfather clauses to avoid inequitable results for taxpayers and insurers alike. This is especially true in the context of section 7702[3] of the Internal Revenue Code and subsequent amendments thereto, which Congress explicitly chose to apply on a prospective basis.

As with many provisions of the tax law, there is not always perfect clarity on how the various grandfather clauses applicable to life insurance contracts should be applied in practice. The courts have never ventured into this territory, and the Internal Revenue Service (the "Service") has issued little guidance,[4] leaving taxpayers largely on their own over the past three decades to interpret the statutory language of the grandfather provisions and their accompanying legislative histories. However, the Service recently released a chief counsel advice memorandum that provides insight into the Service's thinking on certain aspects of the grandfather clauses applicable to section 7702.[5] In Chief Counsel Advice Memorandum 200805022 (Aug. 17, 2007) (the "CCA"), the Service essentially concludes that two common occurrences under a typical universal life insurance contract—the addition of a qualified additional benefit rider and a change in death benefit options—will cause a loss of grandfathering under the effective date provisions that govern the applicability of section 7702 and the 1988 amendments thereto in cases where such changes are not pursuant to a right in the contract.

Unfortunately, the analysis that the CCA presents in support of these conclusions suffers from certain inadequacies, particularly by failing to address (1) the interaction between the relevant effective date provisions and the so-called "adjustment rules" of sections 101(f) and 7702, and (2) the absence of a "material change" rule in the context of the effective date provisions governing the 1988 amendments to section 7702. These deficiencies, as well as others, call into question the accuracy of the conclusions that the CCA reaches. This article summarizes the applicable grandfather clauses and the Service's interpretation of them as expressed in the CCA, and it then offers an alternative analysis that the authors believe represents a better reasoned (or at least a reasonable) approach to applying the grandfather rules.

Grandfathered Life Insurance Contracts

Section 101(f) was added to the tax code by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[6] The provision was the first-ever definition of a "life insurance contract" to appear in the tax code, and required "flexible premium life insurance contracts" to satisfy one of two alternative tests in order to be afforded the favorable tax treatment that accompanies a characterization as life insurance. Section 101(f) applies only to flexible premium life insurance contracts issued before Jan. 1, 1985.[7]

Section 7702 was added to the Code by the Deficit Reduction Act of 1984 (DEFRA).[8] It provides a definition of a "life insurance contract" for all purposes of the Code, under which any life insurance contract (not just a flexible premium contract) must satisfy one of two alternative tests that are similar to the alternative tests under section 101(f). Certain computational rules apply for purposes of these tests, including rules relating to the mortality and expense charges that can be taken into account in applying the tests. In 1988, section 7702 was amended by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA)[9] to impose more restrictive rules with respect to the mortality and expense charges that can be assumed under section 7702 (the "Reasonable M&E Rules").

Section 7702 generally applies to "contracts issued after Dec. 31, 1984, in taxable years ending after such date" (the "DEFRA Effective Date").[10] In other words, contracts issued on or before Dec, 31, 1984, are grandfathered so that section 7702 does not apply to them. In regard to this statutory rule, the explanation of DEFRA by the Senate Finance Committee states that:

> Contracts issued in exchange for existing contracts after December 31, 1984 are to be considered new contracts issued after that date. For these purposes a change in an existing contract will not be considered to result in an exchange, if the terms of the resulting contract (that is, the amount or pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, or mortality and expense charges) are the same as the terms of the contract prior to the change. Thus, a change in minor administrative provisions or a loan rate generally will not be considered to result in an exchange.[11]

The description of the DEFRA Effective Date by the staff of the Joint Committee on Taxation expanded on this, stating that:

> For purposes of applying the effective date provisions ... the issue date of a contract is generally the date on the policy assigned by the insurance company, which is on or after the date the application was signed. ... Contracts issued in exchange for existing contracts after December 31, 1984, are to be considered new contracts issued after that date. ... In addition, a change in an existing contract will not be considered to result in an exchange, if the terms of the resulting contract (that is, the amount or pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, or mortality and expense charges) are the same as the terms of the contract prior to the change. Thus, a change in minor administrative provisions or a loan rate generally will not be considered to result in an exchange.[12]

Section 5011(d) of TAMRA states that the Reasonable M&E Rules apply to "contracts entered into on or after Oct. 21, 1988" (the "TAMRA Effective Date"). In other words, contracts entered into before Oct. 21, 1988, are grandfathered from application of the Reasonable M&E Rules. The effective date of these amendments, as originally proposed as part of the Miscellaneous Revenue Act of 1988 (the "1988 Bill"),[13] which later became TAMRA, was phrased quite differently. Specifically, section 346(c) of the 1988 Bill provided as follows:

> (1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to contracts issued on or after July 13, 1988.
>
> (2) TREATMENT OF MATERIAL CHANGES.—The rules of section 7702A(c)(3) of the 1986 Code (as added by this Act) [relating to material changes] shall apply in determining whether a contract is issued on or after July 13, 1988.

The explanation of the 1988 Bill by the House Ways and Means Committee restated this rule as follows:

> The provision generally is effective for all life insurance contracts issued on or after July 13, 1988, and for all life insurance contracts that are materially changed on or after July 13, 1988. A material change for this purpose has the same meaning as a material change under the provisions relating to modified endowment contracts. …[14]

In the conference agreement for TAMRA, the effective date rule was modified to reference "contracts entered into on or after October 21, 1988." The language addressing material changes was deleted. The conference report for TAMRA provides no explanation for the change, simply stating that "[t]he conference agreement follows the House bill, with modifications. … The provision is effective with respect to contracts entered into on or after October 21, 1988."[15]

The CCA

The CCA addresses the application of the DEFRA and TAMRA grandfather clauses just described in the context of two specific types of changes to existing flexible premium universal life insurance contracts that the taxpayer life insurance company had issued. Some of the contracts were issued before Jan. 1, 1985 (the "Pre-DEFRA Contracts"), and, accordingly, were subject to the requirements of section 101(f), rather

continued 10

from pg. 9

than the requirements of section 7702, absent an event that caused a loss of grandfathering under the DEFRA Effective Date. Other contracts were issued after Dec. 31, 1984, but before Oct. 21, 1988 (the "Pre-TAMRA Contracts"), and, accordingly, were subject to section 7702 but not the Reasonable M&E Rules, absent a loss of grandfathering under the TAMRA Effective Date.

The taxpayer life insurance company requested rulings that a change from an "option 2" or increasing pattern of death benefit to an "option 1" or level death benefit pattern (a "DBO Change") or the addition of a rider that provided a qualified additional benefit (a "QAB Rider") would not cause a loss of grandfathering under these provisions. With regard to DBO Changes, the CCA states that the contracts as originally issued provided only for an option 2 death benefit and, significantly to the CCA's reasoning, did not expressly provide contract owners with the ability to obtain an option 1 death benefit. Similarly, the CCA states that the express terms of the contracts did not address QAB Riders, although the taxpayer had a practice of allowing contract holders to add them with evidence of insurability.

> The analysis provided in the CCA is somewhat elliptical in that it appears to omit several key points. …

The Service reached an adverse conclusion on the taxpayer's request for rulings, concluding that a DBO Change or the addition of a QAB Rider would trigger a loss of grandfathering under the DEFRA Effective Date and the TAMRA Effective Date, as applicable. This conclusion prompted the taxpayer to exercise its procedural right to withdraw the request before a negative ruling was issued. The CCA was issued when the National Office of the Service (which handles ruling requests) exercised its own procedural right to notify the operating division of the Service with examination jurisdiction over the taxpayer's tax return that the ruling request had been withdrawn and to give its views on the issues presented in the request.[16]

In explaining its views on the issues presented in the request, the Service quoted the Joint Committee on Taxation's explanation of the DEFRA Effective Date and concluded that it established a "negative inference" that a DBO Change or the addition of a QAB Rider would cause a loss of grandfathering under the facts presented. With regard to the TAMRA Effective Date, the Service cited the House Ways and Means Committee report on the 1988 Bill, which, as quoted above, refers to an effective date provision in terms of contracts "issued" or "materially changed" on or after a certain date.[17] The Service acknowledged that the TAMRA conference report stated that the conference agreement followed the 1988 Bill "with modifications," but the Service did not discuss the fact (noted above) that one of those "modifications" was to eliminate all references to "material changes" to contracts. Rather, the Service concluded that the "material change" language in the 1988 Bill "will cause a life insurance contract to be entered into anew (for purposes of [the Reasonable M&E Rules]) if there is an increase in future benefits." In that regard, the Service stated that:

> We read the intent expressed in the House Report together with the acquiescence of the Conference Agreement to follow the House Bill, with modifications, to trigger the loss of grandfathering on the facts presented by the Taxpayer. To do otherwise would virtually eliminate the ability to lose grandfathered status except in the clearest of circumstances (new contracts actually issued after the effective date or tax avoidance) and does not follow the intent of Congress.

Alternative Analysis

The analysis provided in the CCA is somewhat elliptical in that it appears to omit several key points that could be considered persuasive in arguing for a conclusion contrary to that reached in the CCA—that the DBO Change or addition of a QAB Rider addressed therein does not trigger a loss of grandfathering under the DEFRA Effective Date or the TAMRA Effective Date. Perhaps most significantly, the CCA does not address the interaction between the relevant effective date provisions and the so-called "adjustment rules" under sections 101(f) and 7702.

In that regard, section 7702(f)(7)(A) provides that "[i]f there is a change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination or adjustment made under this section, there shall be proper adjustments in future determinations made under this section." The legislative history of this provision elaborates as follows:

> Changes in the future benefits or terms of a contract can occur at the behest of the company or the policyholder, or by the passage of time. However, proper adjustments may be different for a particular change, depending on which alternative test is being used or on whether the changes result in an increase or decrease of future benefits. In the event of an increase in current or future benefits, the limitations under the cash value accumulation test must be computed treating the date of change, in effect, as a new date of issue for determining whether the changed contract continues to qualify as life insurance under the definition prescribed in the Act. … Under the guideline premium limitation, an adjustment is required under similar circumstances, but the date of change for increased benefits should be treated as a new date only with respect to the changed portion of the contract.[18]

In this connection, the legislative history also explains the interaction between the adjustment rule and the DEFRA Effective Date in the context of a particular type of change to a contract as follows:

> [F]or purposes of the adjustment rules, any change in the terms of a contract that reduces the future benefits under the contract will be treated as an exchange of contracts (under sec. 1035). Thus, any distribution required under the adjustment rules will be treated as taxable to the policyholder under the generally applicable rules of section 1031 [regarding taxable "boot" treatment of cash or other property received in a like-kind exchange]. This provision was intended to apply specifically to situations in which a policyholder changes from a future benefits pattern taken into account under the computational provision for policies with limited increases in death benefits [*i.e.*, an "option 2" death benefit pattern] to a future benefit of a level amount [*i.e.*, an "option 1" death benefit pattern] (even if at the time of the change the amount of the death benefit is not reduced). … The provision that certain changes in future benefits be treated as exchanges was not intended to alter the application of the transition rules for life insurance contracts. … Thus, section 7702 will not become applicable to a contract that was issued before January 1, 1985, because a reduction of the contracts [sic] future benefits resulted in the application of this adjustment provision.[19]

Like section 7702, section 101(f) includes a rule requiring adjustments to be made to determinations thereunder in the event of a change in the future benefits of a life insurance contract subject to section 101(f). Specifically, section 101(f)(2)(E) states that "[t]he guideline single premium and guideline level premium shall be adjusted in the event of a change in the future benefits or any qualified additional benefit under the contract which was not reflected in any guideline single premiums or guideline level premium previously determined."

DEFRA Effective Date. Turning first to the application of the DEFRA Effective Date, the adjustment rule in section 101(f)(2)(E) would appear to apply, by its terms, to any Pre-DEFRA Contract "in the event of a change in the future benefits or any qualified additional benefit under the contract. …" In this regard, a DBO Change would appear to be a change in the future benefits of a Pre-DEFRA Contract, and the addition of a QAB Rider would appear to be a change in the QABs under a Pre-DEFRA Contract. It would also seem clear that only one result—either the application of the adjustment rule, or else the "new contract" treatment brought about by the application of the DEFRA Effective Date—could apply in the case of a DBO Change or the addition of a QAB Rider. While the Service apparently would contend that the latter result would apply in such a case, such a position seemingly conflicts with principles of statutory construction.

When a conflict arises between two statutory rules, principles of statutory construction adopted by the Supreme Court dictate that the specific governs the general.[20] Section 101(f)(2)(E) provides a very specific,

continued 12

from pg. 11

statutory rule that, on its face, would appear to apply to the changes that were made to the flexible premium universal life insurance contracts involved in the CCA (section 101(f) applies solely to flexible premium contracts like the Pre-DEFRA Contracts). In contrast, the DEFRA Effective Date provides only a briefly stated, general rule, and one that is applicable to *all* forms of life insurance (flexible premium or not). Moreover, the section 101(f)(2)(E) adjustment rule is itself a material change rule, and to the extent that the DEFRA Effective Date also represents a rule addressing material changes in contracts, the adjustment rule is the more specific statutory provision.

In contrast, the DEFRA Effective Date provides only a briefly stated, general rule, and one that is applicable to *all* forms of life insurance (flexible premium or not).

Furthermore, the notion that a change in the "amount or pattern of death benefit" under a contract (such as a DBO Change) results in the application of the DEFRA Effective Date derives solely from the legislative history of section 7702. It arises by negative implication, as the Service recognized in the CCA, for the legislative history merely says that if there is no change in, *inter alia,* the amount or pattern of a contract's death benefit, the contract will *not* be treated as issued after the DEFRA Effective Date. Prior to the CCA's release, in no guidance whatsoever—no regulation (proposed or final), no notice, no revenue ruling, and not even a private letter ruling—had the Service ever described a circumstance in which grandfathering under DEFRA (or TAMRA) was forfeited due to contract changes, or what the result would be. For that matter, the DEFRA legislative history does not even mention the addition of a QAB. If, as advanced above, a specific statutory rule governs a general statutory rule, then arguably a specific statutory rule—the section 101(f)(2)(E) adjustment rule—governs a non-statutory, general concept that arises only by negative inference. And absent guidance from the Service to the contrary (at least up to the point when the CCA was released), there has been no reason for a taxpayer familiar with the adjustment rule to think otherwise.

Moreover, if, through negative implication, the DEFRA legislative history is read to result in a loss of grandfathering upon a change in, *inter alia*, a contract's "amount or pattern of death benefit," then section 101(f)(2)(E) will never apply to any change in the "future benefits" of a contract, absent an express right in the contract to make the change. This follows from the fact that the change in the "amount or pattern of death benefit" referenced in the DEFRA legislative history is also a change in the "future benefits" under a contract described in the section 101(f)(2)(E) adjustment rule. In enacting both section 101(f) and section 7702, Congress was arguably aware of the flexible nature of universal life insurance contracts and, in particular, that future benefits can be changed and that riders can be added and dropped. Indeed, flexible premium contracts—presumably such as those involved in the CCA—make provisions in their cash value computations for the addition and deletion of rider charges, even if there is no express "right" to do so. It was for this reason that the adjustment rule was created, thereby ensuring that the limitations on investment orientation imposed under the new statutes would continue to apply in an effective manner after such changes occurred. Since Congress, in enacting DEFRA (including, obviously, the DEFRA Effective Date), left section 101(f) and its adjustment rule in place rather than repealing them, and such rule applies to all changes in future benefits and QABs (even if there is no preexisting right to make the change), it seemingly would make little sense to construe section 101(f)'s adjustment rule as having no meaning after Jan. 1, 1985, for many common changes to contracts.

On the other hand, if the adjustment rule applies in the case of changes in Pre-DEFRA Contracts, the DEFRA Effective Date still retains significant meaning. Unlike section 101(f), which governs only flexible premium contracts, section 7702 governs all types of life insurance contracts (issued after 1984). For contracts other than universal life, which were not subject to any limits on investment orientation but which comprised the vast majority of in-force contracts on Jan. 1, 1985, Congress intended to apply section 7702 prospectively, including after material changes were made to such contracts following the DEFRA Effective Date. Interpreting the section 101(f)(2)(E) adjustment rule as continuing to apply to Pre-DEFRA Contracts after the DEFRA Effective Date is fully consistent with this structure, enabling such contracts to be governed by the adjustment rule while applying the DEFRA Effective Date in all other appropriate contexts.[21]

Finally, the DEFRA legislative history provides support for the use of the adjustment rule in this context. As originally enacted, section 7702(f)(7)(B) provided that a reduction in future benefits subject to the section 7702(f)(7)(A) adjustment rule would be treated as an "exchange" of contracts, giving rise to "boot" treatment for amounts that the adjustment rule required to be distributed from a contract to maintain compliance with the contract's guideline premium limitation. Even so, the DEFRA legislative history made it clear that such a change in benefits was not intended to impair grandfathering of Pre-DEFRA Contracts.[22] Moreover, when section 7702(f)(7)(B) was amended in 1986 (retroactively to Jan. 1, 1985) to replace the boot treatment with the so-called "recapture" rules of section 7702(f)(7)(B)-(E), the legislative history again explained that "exchange" treatment for contract changes under the adjustment rule does not result in "new contract" treatment for purposes of the DEFRA Effective Date. Specifically, the 1986 legislative history stated that "[t]he provision that certain changes in future benefits be treated as exchanges … only applies with respect to such changes in contracts issued after December 31, 1984."[23]

We recognize that the legislative history relating to the DEFRA Effective Date includes discussion confirming that a contract change that represents the exercise of an option in a contract does not cause the contract to be newly issued for purposes of this effective date rule. This, in turn, may imply that a change not made pursuant to an option does cause the contract to be newly issued. Again, while this result may make some sense in some contexts—such as for Pre-DEFRA Contracts that are not subject to section 101(f)—as a matter of statutory interpretation the more specific adjustment rule of section 101(f)(2)(E) seemingly should govern the treatment of all changes to a contract that is subject to section 101(f).

TAMRA Effective Date. Turning next to the application of the TAMRA Effective Date, the fact that the transition rule is based on the date that a contract is "entered into" supports the proposition that a DBO Change or the addition of a QAB Rider does not cause a loss of grandfathering. Although TAMRA does not define "entered into" or elaborate in any way on its meaning in the context of the TAMRA Effective Date (a point the Service itself has recognized),[24] the plain meaning of the term, as evidenced by its dictionary definition and the Service's statements in other contexts, is that "entered into" is the action by the owner and the insurance company to become parties to a binding contractual relationship. Arguably, a DBO Change or the addition of a QAB Rider to a Pre-TAMRA Contract does not alter that action or the date on which it occurred, and thus does not alter the date that the Contract was "entered into" for purposes of the TAMRA Effective Date.

Additional support for a continuation of grandfathering can be drawn from the statutory structure itself and the related legislative history. The modified endowment contract ("MEC") rules of section 7702A were enacted contemporaneously with the Reasonable M&E Rules, and both sets of rules apply to contracts "entered into" after a specified date in 1988. For purposes of the MEC rules, TAMRA included a number of special provisions that modified the normal meaning of "entered into," including a rule that certain death benefit increases or additions of QABs would cause a loss of grandfathering. Congress could have added similar special provisions to modify the meaning of "entered into" for the Reasonable M&E Rules, but it chose not to do so. One might point to principles of statutory construction adopted by the Supreme Court for the proposition that when Congress includes special rules in one part of a statute but omits them from another, it must be presumed to have done so intentionally.[25] On this basis, one might conclude that Congress did not intend to include the special rules modifying the normal meaning of "entered into" for purposes of the Reasonable M&E Rules. Also, this action by Congress in the context of the MEC effective date provision offers strong evidence that the normal meaning of "entered into," as described above, is correct, because if changes in benefits or QABs in and of themselves caused a contract to be newly entered into, there would have been no need to include the special rules under the MEC effective date provision that treat these types of changes as resulting in a newly entered into contract.

Moreover, the TAMRA legislative history shows that Congress rejected a previously proposed "material change" rule in the context of the TAMRA Effective Date. As described above, prior to modification by the conference committee, the House version of TAMRA stated that the Reasonable M&E Rules were to be effective for contracts "issued" on or after July 13, 1988, and that a contract that was materially changed (within the meaning of then new section 7702A(c)(3)) on or after that date was to be treated as newly issued. In enacting TAMRA, Congress not only changed the TAMRA Effective Date from "contracts issued" to "contracts entered into," but it also dropped the rule that "material changes" would trigger the effective date. This arguably shows that Congress did not intend for changes

continued ▶▶14

from pg. 13

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

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

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

in existing contracts to trigger the TAMRA Effective Date, a point that the Service did not address in the CCA when it noted that the conference agreement adopted the House bill "with modifications." Here, again, principles of statutory construction adopted by the Supreme Court would seem to suggest that where Congress includes limiting language in an earlier version of a bill but deletes it prior to enactment, it may be presumed that the limitation was not intended.[26] Thus, one might conclude that Congress intended to impose the Reasonable M&E Rules only on a *fully prospective* basis, and that a DBO Change or the addition of a QAB Rider to a Pre-TAMRA Contract does not affect the date the Contract was "entered into" for purposes of the TAMRA Effective Date.

Conclusion

The analysis that the CCA presents in support of the conclusions that a DBO Change or the addition of a QAB Rider triggers a loss of DEFRA or TAMRA grandfathering suffers from certain inadequacies. In particular, the CCA fails to address the interaction between the DEFRA Effective Date and the adjustment rules of section 101(f), and it also fails to address the absence of a material change rule in the context of the TAMRA Effective Date. At a minimum, these deficiencies call into question the accuracy of the conclusions that the CCA reaches, and leave open the possibility that other reasonable conclusions might be drawn. Unless the Service issues guidance in a form that is more definitive than a chief counsel advice memorandum (which carries no precedential weight as far as taxpayers generally are concerned), these questions likely will continue to be the subject of debate.

End Notes

1 Black's Law Dictionary (8th ed. 2004). Of course, "grandfather clauses" earned their name from the dishonorable practice in the post-Civil War south of states enacting constitutional provisions that exempted from suffrage restrictions the descendants of men who voted before the Civil War. *See id.* The phrase has since lost its pejorative connotations, at least for those who benefit from such provisions in the tax law.

2 *See, e.g.*, Pub. L. No. 104-191 § 501 (1996) (applying amendments to section 264(a)(4) that eliminated interest deductions for so-called "leveraged COLI" to contracts issued after the original enactment of section 264(a)(4) in 1986).

3 Unless otherwise indicated, each reference to a "section" means a section of the Internal Revenue Code of 1986, as amended (the "Code").

4 Some guidance has been issued with respect to the transition from one prevailing mortality table to another under the reasonable mortality and expense charge rules of section 7702(c)(3)(B)(i). *See, e.g.*, Notice 2006-95, 2006-45 I.R.B. 848. Other guidance from the Service has appeared in the form of private letter rulings that address only a handful of situations: (1) modifications to a life insurance contract to provide that policy loan interest is payable in arrears, rather than in advance (*see, e.g.*, PLR 9737007 (June 11, 1997)); (2) contract changes resulting from an assumption reinsurance transaction, reorganization, and/or demutualization (*see, e.g.*, PLR 200002010 (Sept. 30, 1999)); (3) the assignment of a life insurance contract to a trust and subsequent return of the contract to the taxpayer (PLR 9033023 (May 18, 1990)); (4) an amendment to a contract to allow additional investment options (PLR 8648018 (Aug. 27, 1986)); and (5) the addition of a rider to a life insurance contract that offered an option 2 death benefit that was not available, under the express terms of the contract, as originally issued (PLR 9853033 (Sept. 30, 1998)). *See also* Rev. Proc. 92-57, 1992-2 C.B. 410, providing that certain modifications and restructurings of life insurance contracts issued by a financially troubled insurance company do not upset grandfathers under section 7702.

5 "Chief counsel advice" is written advice or instruction, under whatever name or designation, prepared by any national office component of the Office of Chief Counsel that is issued to field or service center employees of the Service (or regional or district employees of the Office of Chief Counsel) and conveys (1) any legal interpretation of a revenue provision, (2) any IRS or Office of Chief Counsel position or policy concerning a revenue provision, or (3) any legal interpretation of federal, state, or foreign law relating to the assessment or collection of any liability under a revenue provision. Section 6110(i). Chief counsel advice generally may not be used or cited as precedent. *See* section 6110(k) and section 6110(b)(1)(A).

6 Pub. L. No. 97-248.

7 Originally, section 101(f) applied to flexible premium life insurance contracts entered into before January 1, 1984. Section 221(b)(2) of the Deficit Reduction Act of 1984, Pub. L. No. 98-369 (1984), amended section 101(f) to make it applicable to contracts issued before Jan. 1, 1985.

8 Pub. L. No. 98-369 (1984).

[9] Pub. L. No. 100-647.

[10] DEFRA section 221(d)(1).

[11] S. PRT. NO. 98-169, VOL. I, at 579 (1984). The conference report for DEFRA states that, "[w]ith respect to the effective date, the conference agreement follows the Senate amendment, adopting a general effective date that makes the new definitional provisions applicable to contracts issued after Dec. 31, 1984...." H.R. CONF. REP. NO. 98-861, at 1076 (1984).

[12] STAFF OF THE J. COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 655-56 (Comm. Print 1984) ("DEFRA Bluebook").

[13] H.R. 4333, 100TH CONG. (reported July 26, 1988).

[14] H.R. Rep. No. 100-795, at 545-46 (1988).

[15] H.R. CONF. REP. NO. 100-1104, VOL. I, at 108 (1988).

[16] The revenue procedure governing private letter ruling requests states that "[i]f a taxpayer withdraws a letter ruling request …, the Associate office generally will notify, by memorandum, the appropriate Service official in the operating division that has examination jurisdiction of the taxpayer's tax return and may give its views on the issues in the request to the Service official to consider in any later examination of the return…. If the memorandum to the Service official … provides more than the fact that the request was withdrawn and the Associate office was tentatively adverse, or that the Associate office declines to issue a letter ruling, the memorandum may constitute Chief Counsel Advice, as defined in § 6110(i)(1), and may be subject to disclosure under § 6110." Section 7.07 of Rev. Proc. 2007-1, 2007-1 I.R.B. 1 (which applied at the time the CCA was issued). *See also* Rev. Proc. 2008-1, 2008-1 I.R.B. 1 (which includes an identical provision with respect to ruling requests filed in 2008).

[17] *See* text accompanying note 14, *supra.*

[18] DEFRA Bluebook, *supra* note 12, at 653-54.

[19] *Id.* at 654.

[20] *See* Morales v. Trans World Airlines, Inc., 504 U.S. 374, 384-85 (1992) ("it is a commonplace of statutory construction that the specific governs the general.") (citing Crawford Fitting Co. v. J. T. Gibbons, Inc., 482 U.S. 437, 445 (1987)); NORMAN J. SINGER, STATUTES AND STATUTORY CONSTRUCTION, Vol. 3A § 66.03, at 17 (5th ed. 1992) ("[w]here there is a conflict in taxing statutes, the specific controls the general.") (citing State v. Franco Novelty Co., Inc., 299 So. 2d 737 (Ala. 1974)).

[21] It is also noteworthy that treating a contract as newly issued rather than applying the adjustment rule at the time of a change in the contract's benefits can have potentially unwarranted results by increasing the contract's guideline premium limitation due to the insured's increased age at the time of the change. This can result, in turn, in an unwarranted increase in a contract's allowable investment orientation. Applying the adjustment rule would preclude such results; at minimum, in view of the fact that new contract treatment could lead to such results whereas application of the adjustment rule would not, it would be reasonable to conclude that the adjustment rule should apply.

[22] See text accompanying note 19, *supra.*

[23] STAFF OF THE J. COMM. ON TAX'N, 99TH CONG., EXPLANATION OF TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1984 AND OTHER RECENT TAX LEGISLATION, at 107 (Comm. Print 1987).

[24] *See* PLR 9150045 (Sept. 17, 1991).

[25] Russello v. United States, 464 U.S. 16, 23 (1983) (quoting United States v. Wong Kim Bo, 472 F.2d 720, 722 (5th Cir. 1972)); see also City of Chicago v. Environmental Defense Fund, 511 U.S. 328, 338 (1994); Keene Corporation v. United States, 508 U.S. 200, 208 (1993); United States v. Naftalin, 441 U.S. 768, 773-74 (1979); United States v. Wooten, 688 F.2d 941, 950 (4th Cir. 1982).

[26] Russello v. United States, 464 U.S. at 23-24.

NAIC Proposal for Mortality Under Pre-Need Life Insurance

by John T. Adney, Craig R. Springfield, Brian G. King and Alison L. Reynolds

The National Association of Insurance Commissioners (NAIC) has exposed for comment a draft model regulation that proposes the establishment of new minimum mortality standards for reserves and non-forfeiture values for pre-need life insurance (the Draft Pre-Need Model or Model). In this article, we first describe certain features of the Draft Pre-Need Model, which has thus far been approved by the Life and Health Actuarial Task Force. After this, we discuss the implications of adoption of the Model in regard to both the so-called federally prescribed reserves under section 807(d) and calculations under sections 7702 and 7702A defining "life insurance contract" and "modified endowment contract," respectively, under the tax law. (The comments in this article relate to the Feb. 7, 2008 draft of the Model.)

The Draft Pre-Need Model

Rule proposed. The Draft Pre-Need Model provides that "for preneed insurance contracts … and similar policies and contracts, the minimum mortality standard for determining reserve liabilities and non-forfeiture values for both male and female insureds shall be the Ultimate 1980 CSO." The Ultimate 1980 CSO, in turn, means the Commissioners' 1980 Standard Ordinary Life Valuation Mortality Tables without 10-year selection factors, as incorporated into the 1980 amendments to the NAIC Standard Valuation Law approved in December 1983 (1980 CSO). The Draft Pre-Need Model contains transition rules, *e.g.*, generally permitting continued use of the 2001 Commissioners' Standard Ordinary Mortality Table (2001 CSO) for pre-need policies issued before Jan. 1, 2012.

Contracts covered. The Pre-Need Model applies only in respect of "preneed insurance contracts," which are defined in the Model as "any life insurance policy or certificate that is issued in combination with, in support of, with an assignment to, or as a guarantee for a prearrangement agreement for goods and services to be provided at the time of and immediately following the death of the insured." In addition, the definition states that the status of a policy or certificate as a "preneed insurance contract" is determined at the time of issue in accordance with the policy form filing. As previously noted, the rule proposed also applies to "similar policies and contracts."

Purpose. The purpose of the Draft Pre-Need Model is described in part in a drafting note set forth in the Model. Specifically, the drafting note observes that research conducted by the Deloitte University of Connecticut Actuarial Center and commissioned by the Society of Actuaries as part of a study of pre-need mortality "determined that the 2001 CSO Mortality Table … produced inadequate reserves for policies issued in support of a prearrangement agreement which provides goods and services at the time of an insured's death."

Effective date. The Draft Pre-Need Model is proposed to be applicable to pre-need insurance policies and certificates and similar contracts and certificates issued on or after Jan. 1, 2009.

Section 807(d)

Section 807(d) sets forth the rules governing the reflection of life insurance reserves for purposes of determining life insurance company taxable income, and, in this regard, section 807(d)(2)(C) provides that the amount of the federally prescribed reserve—the maximum amount of the deductible reserve for a contract, unless the contract's net surrender value is greater—is determined using, *inter alia*, the "prevailing commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account." Section 807(d)(5)(A), in turn, states that "the term 'prevailing commissioners' standard tables' means, with respect to any contract, the most recent commissioners' standard tables prescribed by the [NAIC] which are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 States when the contract was issued."

If the Draft Pre-Need Model is adopted by the NAIC, and then adopted by at least 26 states, 1980 CSO would, subject to the following discussion regarding transition rules, constitute the prevailing commissioners' standard tables for pre-need contracts issued on or after the date of the adoption of the Model by the 26th state. At present, the 2001 CSO tables are the prevailing commissioners' standard tables under section 807(d) for all life insurance contracts, including pre-need contracts. Thus, adoption of the Model by the NAIC and 26 states would undo the effect of the adoption of 2001 CSO for pre-need contracts—an unprecedented step as far as section 807(d) is concerned. In considering the scope of the proposed change, one issue regards the meaning of the term "preneed insurance contract" as set forth in the Model. The-Model includes a definition of this term, which is helpful. At the same time, the Model's operative rule—requiring use of 1980 CSO—states that it also applies to "similar policies and contracts," which is less clear.

In defining the "prevailing commissioners' standard tables," section 807(d)(5)(B) provides for transitional relief, allowing insurance companies to continue to treat a table as prevailing during the three-year period following the year during which a new table is approved by the 26th state. Thus, for example, if the Model, as prescribed by the NAIC, was adopted by the 26th state during 2009, it would be permissible to continue to use 2001 CSO for pre-need contracts issued during 2010-2012. On closer analysis, there may be some question about the interrelationship between the three-year transition rule and the basic rule of section 807(d)(5)(A) set forth above. On the one hand, this three-year transition rule is permissive, since section 807(d)(5)(B) states that an insurance company "may" apply the three-year rule and, conversely, seemingly could choose not to apply such rule (*i.e.*, an insurance company could choose to apply the Model and 1980 CSO for pre-need contracts issued on and after the date of the approval of the Model by the 26th state, assuming this is after the effective date of the Model).

Thus, 2001 CSO is currently the prevailing table for contracts issued beginning Jan. 1, 2008.

On the other hand, one question that would need to be addressed is whether the transition rule set forth in the Draft Pre-Need Model affects the identification of the "most recent" commissioners' standard mortality tables "permitted to be used in computing reserves for that type of contract" for purposes of section 807(d)(5)(A). If it does, then 2001 CSO—being more recent than 1980 CSO, based on the dates when the tables were developed—may constitute the prevailing commissioners' standard tables during such transition period, and it therefore may not be permissible to use 1980 CSO during the Model's transition period. Alternatively, the date of adoption by the NAIC of a particular commissioners' standard tables for a type of contract may control for purposes of determining the mortality table that is most recent. This issue has not arisen before, as there has not been a reversion to a prior mortality table during the nearly quarter-century history of section 807(d). (It would seem that this technical issue might be avoided—or at least that the issues might be lessened—if the NAIC defined a new mortality table, perhaps called the "2009 Pre-Need Mortality Table," to apply to pre-need contracts, even if such table was equivalent to 1980 CSO.)

Another consideration regards how to treat pre-need contracts issued from Jan. 1, 2008 through the date when 1980 CSO becomes the prevailing table for such contracts for purposes of section 807(d). Because 2001 CSO was adopted by the 26th state during 2004, the three-year transition period described above, which permitted continued use of 1980 CSO, ended on Dec. 31, 2007. Thus, 2001 CSO is currently the prevailing table for contracts issued beginning Jan. 1, 2008. This is somewhat anomalous in view of the finding re-

continued 18

from pg. 17

flected by the drafting note contained in the Draft Pre-Need Model that "… the 2001 CSO Mortality Table … produced inadequate reserves for policies issued in support of a prearrangement agreement which provides goods and services at the time of an insured's death."

At this time, it is not clear how this anomaly should be reconciled with the statutory rules. One suggestion that has been made is that, in circumstances where an insurer applies 1980 CSO for such contracts for statutory reserving purposes, section 807(d)(2)(C) already includes a mechanism to reflect 1980 CSO—specifically, the language in this rule permitting reflection of the prevailing commissioners' standard tables for mortality "adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account." In effect, a known attribute of pre-need contracts—*i.e.*, that they are purchased in connection with a prearrangement agreement for goods and services to be provided at the time of and immediately following the death of the insured—would be viewed as a circumstance similar to an underwriting record evidencing a substandard risk that justifies an adjustment to the prevailing mortality tables under section 807(d)(2)(C).

If a pre-need contract is issued with guarantees based on 2001 CSO (*e.g.*, because the contract was issued in a state that had not adopted the Model), but 1980 CSO comes to represent the prevailing commissioners' standard tables under section 807(d), it seemingly would be permissible to reflect 1980 CSO in determining the federally prescribed reserves for the contract under section 807. However, in such instances, the rule in section 807(d)(1)—generally limiting the reserve deduction for any contract to an amount not in excess of the amount taken into account for the contract in determining statutory (annual statement) reserves—often would be applicable.

Sections 7702 and 7702A

For federal tax purposes, section 7702 defines a "life insurance contract" and section 7702A defines a "modified endowment contract." Similar to the discussion of reserves above, the determination of guideline premiums, net single premiums and 7-pay premiums under these provisions is in part made on the basis of a mortality charge assumption. More specifically, section 7702(c)(3)(B)(i)—which directly or by cross reference generally governs for these purposes—states that the calculations must be based on "reasonable mortality charges which 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."

By cross-referencing section 807(d)(5), section 7702 generally permits use of the same mortality assumption as permitted to be reflected in calculating the federally prescribed reserves, as described above. Thus, if the Draft Pre-Need Model is adopted by the NAIC, and then is further adopted by at least 26 states, 1980 CSO would appear to constitute the prevailing commissioners' standard tables for purposes of sections 7702 and 7702A, subject to the discussion above regarding the Model's transition rules. In considering the effect of the Model on calculations under sections 7702 and 7702A, it is necessary to take account of the effect, if any, of the various notices and other guidance that the Internal Revenue Service ("IRS") has issued on mortality, *e.g.*, Notice 2006-95. Significantly, the notices establish safe harbors that are available to all life insurance contracts, including pre-need contracts, *i.e.*, if the conditions to application of a safe harbor are satisfied, the assumption made with respect to mortality will be deemed to meet the requirements of section 7702(c)(3)(B)(i). None of the safe harbors described in the notices, however, will apply to allow use of 1980 CSO for a contract issued after Dec. 31, 2008. Thus, subject to the discussion in the next paragraph, if 1980 CSO is desired to be used for such a contract's section 7702 and 7702A calculations, it generally will be necessary to rely on the statutory rule in section 7702(c)(3)(B)(i) as the sole governing authority. (In light of the reference to "reasonable mortality charges," there is necessarily some uncertainty regarding the scope of this rule.)

Reflection of mortality higher than 2001 CSO may be justifiable after 2008 for reasons similar to the discussion above relating to the adjustment language of section 807(d)(2)(C). In particular, where a contract's guarantees are based on 1980 CSO mortality, it may be appropriate to reflect 1980 CSO in calculations under sections 7702 and 7702A based on section 5011(c)(2) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647 (the TAMRA Interim Rule), which views mortality charges as meeting the requirements of section 7702(c)(3)(B)(i) where such charges "do not differ materially from the charges actually expected to be imposed by the company (taking into account any relevant characteristic of the insured of which the company is aware)." In some cases (*e.g.*, ordinary whole life insurance contracts), the applicable cash values may always reflect guaranteed mortality charges, *i.e.*, they would be imposed in full and thus use of such charges would not seem to differ in any respect from the charges expected to be imposed. The scope of the TAMRA Interim Rule is unclear, *e.g.*, regarding whether knowledge that a contract is a pre-need contract would be viewed as defining a relevant characteristic of the insured of which the company is aware for purposes of this rule.

As a final point, we note that section 7702(e)(2)(C) permits reflection of death benefit increases in the calculation of net single premiums under the cash value accumulation test if certain conditions are met and the contract "was purchased to cover payment of burial expenses or in connection with prearranged funeral expenses." This rule, and also use of 1980 CSO—relative to 2001 CSO—generally have the effect of increasing net single premiums, and thus the permissible cash values, under such contracts. At the same time, the stated purpose of the Draft Pre-Need Model seems to be the overarching consideration in support of use of the new Model and 1980 CSO—*i.e.*, 2001 CSO produces inadequate reserves for pre-need contracts, and it is believed that a move to 1980 CSO is necessary to correct this problem. It is also worth noting that the tax law generally permits the continued use of 1980 CSO for life insurance contracts issued through the end of 2008 where the mortality guarantees of such contracts are based on 1980 CSO. Thus, the Model, once it is effective to define the prevailing commissioners' standard tables for pre-need contracts, will allow use of the same mortality assumption that is permitted today.

Thus, the Model, once it is effective to define the prevailing commissioners' standard tables for pre-need contracts, will allow use of the same mortality assumption that is permitted today.

Conclusion

The adoption of special commissioners' standard mortality tables for pre-need contracts by the NAIC and at least 26 states will have important consequences for both reserve deductions and calculations under sections 7702 and 7702A for such contracts. It will be interesting to see how this unfolds, in view of the unprecedented nature of this step, and given its consequences for contract design, systems and taxes. As a draft, the Model is still undergoing review within the NAIC process. Stay tuned!

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

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

Brian G. King, FSA, MAAA, is a managing director, Life Actuarial Services with SMART Business Advisory and Consulting and may be *reached at bking@smartgrp.com*.

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

What Does *Textron* Mean for Preserving the Confidentiality of Tax Accrual Workpapers?

by Samuel A. Mitchell and Peter H. Winslow

In-house tax managers are perennially concerned that the Internal Revenue Service (IRS) will request their tax accrual workpapers during an audit, as a result of the Supreme Court decision that no general privilege applies to tax accrual workpapers. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984). Nevertheless, the IRS has long recognized that the fear of disclosure of tax accrual workpapers could cause tax managers to be less forthcoming in their dealings with financial auditors and in Security Exchange Commission (SEC) filings. Therefore, the IRS has had a longstanding formal policy of restraint in requesting the workpapers. *See* Internal Revenue Manual (IRM) 4.10.20.3.1.

Two relatively recent developments have heightened tax managers' anxiety concerning the possible disclosure of tax accrual workpapers. The first involves the IRS's war on corporate tax shelters. In recent years, the IRS has leveraged its legal right to obtain tax accrual workpapers into a tax shelter deterrent. In an attempt to make corporate taxpayers pay a price for engaging in questionable tax practices, the IRS in 2002 formally adopted a policy that all tax accrual workpapers will be requested when the taxpayer has invested in more than one listed transaction or if the taxpayer has not disclosed its participation in a listed transaction. *See* Announcement 2002-63, 2002-2 C.B. 72 (June 17, 2002), incorporated in IRM 4.10.20.3.2. The second, more recent development, is the Financial Accounting Standards Board (FASB)'s adoption of FIN 48[1], which requires corporations to prepare and maintain detailed documentation of the legal and factual support for their provisions for uncertain tax positions. Disclosure of the FIN 48 compliance portion of tax accrual workpapers could provide IRS auditors with a road map for potential audit issues. The IRS has repeatedly stated that it has not changed its policy of restraint in requesting tax accrual workpapers to take advantage of the increased disclosure requirements of FIN 48. However, it also has repeatedly stated that it is reviewing its policy of restraint. Naturally, the continuing review and reconsideration unnerves practitioners and tax managers alike.

With this background, there has been increasing focus on the scope of the attorney-client privilege and the attorney work-product doctrine as applied to tax accrual workpapers. If one of these privileges applies, IRS auditors cannot obtain the workpapers, regardless of their internal policies regarding tax shelter situations and FIN 48. For this reason, practitioners and tax managers took notice when the court in *United States v. Textron Inc.*, 507 F.Supp.2d 138 (D. R.I. 2007), denied the enforcement of an IRS summons seeking a corporation's tax accrual workpapers on the basis that the attorney work-product doctrine applied.

The Chief Counsel of the IRS has stated that the government will continue to take the position it argued in *Textron* or attempt to limit the case to its unique facts. Moreover, the IRS has appealed the case to the First Circuit Court of Appeals (Doc. No. 07-2631, filed Oct. 31, 2007). The First Circuit's holding will be binding in the entire First Circuit, which covers four northeastern states and Puerto Rico, and will be more influential in other courts around the country than the district court's opinion.

---

[1] *See Role of Outside Tax Advisors in FIN 48 Compliance, 3 Taxing Times 30* (February, 2007).

Work-Product Doctrine

The attorney work-product doctrine generally applies to legal advice prepared for the primary purpose of aiding in anticipation of future litigation.[2] The privilege applies to: (1) materials or communications of a nature that qualifies for protection; (2) that were prepared in anticipation of litigation; and (3) were prepared by or for that party or that party's attorney or other qualifying representative. The attorney work-product doctrine is not the same as the attorney-client privilege. This article deals primarily with the application of the attorney work-product doctrine. In general, the attorney-client privilege applies to advice provided by an attorney to a client. The attorney work-product doctrine applies to advice and the information that is prepared in anticipation of litigation. Disclosure to a third party will waive the attorney-client privilege, but it may be possible to disclose a document to a financial auditor and yet maintain the attorney work-product privilege. The work-product doctrine potentially is broader than the attorney-client privilege, in that it is not limited to confidential attorney-client communications relating to legal services. It includes gathering of facts from discussions with third parties and the lawyer's mental impressions. It also may apply to information with respect to which the attorney-client privilege has been waived.[3] The IRS can overcome the privilege in a summons enforcement proceeding if it shows sufficient cause for the production of the documents and in good faith believes: (1) the work-product sought is necessary to the determination of the taxpayer's tax liability; and (2) the information could not be obtained from any other source.[4]

On appeal in *Textron*, the IRS is arguing among other things that an affirmance of the district court will create a conflict among the circuits. However, there already appears to be some disagreement among the courts in their interpretation of the requirement that work-product materials be prepared "in anticipation of litigation." Some courts apply a primary purpose test. For example, the Fifth Circuit has held that work-product material is prepared in anticipation of litigation "as long as the primary motivating purpose behind the creation of a document was to aid in possible future litigation."[5] *United States v. El Paso,* 682 F.2d 530, 542 (5th Cir. 1982). Other courts apply a less strict "because of" test. Under this test, the material is prepared in anticipation of litigation if it was prepared or obtained "because of" the prospect of litigation. *United States v. Adlman,* 134 F.3d 1194 (2d Cir. 1998). *In United States v. Roxworthy,* 457 F.3d 590 (6th Cir. 2006), the Sixth Circuit applied the "because of" test. The court held that the work-product doctrine applied because the taxpayer had a subjective anticipation of litigation that was objectively reasonable. The taxpayer's anticipation of litigation was objectively reasonable because the taxpayer's return was significant enough to ensure a yearly IRS audit, the transaction at issue involved a $112 million discrepancy between tax loss and book loss, the taxpayer had been advised that the area of law was unsettled and that IRS had recently targeted the type of transaction at issue. Not surprisingly, the IRS recently indicated in AOD 2007-004 (Oct. 1, 2007) that it will not follow *Roxworthy* because it believes that the possibility of an audit is insufficient and the possibility of litigation is too remote if the document is prepared in advance of an audit.

The work-product doctrine can be waived only if the otherwise protected information is divulged to a third party who has no interest in maintaining the confidentiality of a significant part of the work-product. In order to result in a waiver, the disclosure must be wholly inconsistent with the purpose of the privilege to safeguard the attorney's work-product and trial preparation. This means that where attorney work-product is given to an outside auditor who maintains confidentiality, it may be protected from disclosure to the IRS even though the same disclosure may result in a waiver of the attorney-client privilege. For example, in *Laguna Beach County Water Dist. v. Superior Court,* 124 Cal. App.4th 1453 (2004), the court held that there was no waiver of the attorney work-product doctrine when the attorney responded to inquiries by the auditor for the water district relating to the financial effect of pending or threatened litigation. The court held that the disclosure did not result in a waiver because it was consistent with the privilege and the parties did not intend to waive protection (the parties marked each letter with the notation "Attorney-Client and Attorney Work-Product Communication.")

---

[2] *Hickman v. Taylor,* 329 U.S. 495 (1947); Fed. R. Civ. P. 26(b)(3); *United States v. Adlman, 134 F.3d 1194 (2d Cir. 1998).*

[3] *Long-Term Capital Holdings v. United States,* 2003-1 U.S.T.C. 50304.

[4] *Upjohn Co. v. United States,* 449 U.S. 383. *See also* Fed. R. Civ. P. 26(b)(3).

[5] *See also United States v. Rockwell Int'l,* 897 F.2d 1255 (3rd Cir. 1990) and *United States v. Davis,* 636 F.2d 1029 (5th Cir. 1981), applying the more restrictive "primary purpose" test.

continued 22

from pg. 21

Textron Decision

On Aug. 28, 2007, the District Court held that the attorney work-product doctrine protected Textron's tax accrual workpapers and that the IRS had not met the showing of substantial need necessary to obtain an opponent's attorney work-product. Textron engaged in various "listed transactions," including so-called "sale-in, lease out" (SILO) transactions during the 1998-2001 years in dispute. During its audit, the IRS issued a summons for all of Textron's tax accrual workpapers for tax year 2001, on the basis of its policy of requesting all tax accrual workpapers if a taxpayer invests in more than one tax shelter. In Announcement 2002-63, the IRS indicated its position that tax accrual workpapers are not generated in connection with seeking legal or tax advice, but are developed to evaluate a taxpayer's deferred or contingent tax liabilities in connection with a taxpayer's disclosure to third parties of the taxpayer's financial condition, and, therefore, the tax accrual workpapers are not privileged communications. *See also United States v. Telephone Data Systems, Inc.*, 90 A.F.T.R.2d 2002-5828 (where it was insufficient for a taxpayer to argue that, because it was audited regularly by the IRS, it anticipated the audit would lead to federal income tax proceedings, including litigation).

In Announcement 2002-63, the IRS indicated its position that tax accrual workpapers are not generated in connection with seeking legal or tax advice. …

Textron's workpapers consisted of a spreadsheet identifying issues on its tax return that counsel deemed uncertain. Textron used the spreadsheet on a yearly basis to summarize tax reserve items for financial accounting purposes. The spreadsheet indicated in percentage terms the estimates by counsel of the likelihood of prevailing in litigation and corresponding dollar amounts for reserves on each issue. There were additional back-up workpapers containing spreadsheet drafts, the prior year spreadsheet and notes and memoranda of in-house tax attorneys regarding which issues should be included on the spreadsheets. Textron's accountants, in-house counsel and outside counsel prepared the spreadsheets in close cooperation with one another, and the documents reflected the opinions and judgments of the attorneys. Textron provided the final spreadsheet on a confidential basis to Ernst & Young—its independent auditor—during the course of the financial audit.

In the First Circuit, a document is prepared "in anticipation of litigation" if it is prepared "because of litigation." The court in *Textron* held that the tax accrual workpapers satisfied this "because of litigation" test. Specifically, the court stated:

> However, it is clear that the opinions of Textron's counsel and accountants regarding items that might be challenged by the IRS, their estimated hazards of litigation percentages and their calculation of tax reserve amounts would not have been prepared at all "but for" the fact that Textron anticipated the possibility of litigation with the IRS. If Textron had not anticipated a dispute with the IRS, there would have been no reason for it to establish any reserve or to prepare the workpapers used to calculate the reserve. Thus, while it may be accurate to say that the workpapers helped Textron determine what amount should be reserved to cover any potential tax liabilities and that the workpapers were useful in obtaining a "clean" opinion from E&Y regarding the adequacy of the reserve amount, there would have been no need to create a reserve in the first place, if Textron had not anticipated a dispute with the IRS that was likely to result in litigation or some other adversarial proceeding.

507 F.Supp.2d at 150. Thus, even though there were other reasons for preparation of the documents (financial reporting), they were protected from disclosure.

The court held that the attorney-client privilege and the tax practitioner privilege under I.R.C. § 7525 (which generally tracks the attorney-client privilege) applied to the documents, but that Textron waived those privileges when it provided the final spreadsheet to its independent auditors. The attorney-client privilege and the tax practitioner privilege are designed to encourage full and frank discussions with attorneys and tax advisors by keeping the communications confidential. Any action inconsistent with strict confidentiality generally waives the privileges, and many courts have held that providing documents to independent auditors is a waiver. However, the court found that the work-product doctrine—also applicable to the tax accrual workpapers—serves a different purpose and thus has a different waiver standard. The work-product doctrine is designed in part to prevent an adversary in litigation from gaining an unfair advantage by piggy-backing on an opponent's attorney work-product. The privilege is designed to allow an attorney a zone of privacy, free from interference from an adversary.

Accordingly, a waiver of the privilege generally occurs only when the party does something inconsistent with keeping the information from the adversary. Textron provided the spreadsheet to its auditors with the understanding that the auditors would maintain confidentiality and the auditors had a professional obligation to comply. Therefore, the court held that, by providing the spreadsheet to its auditors, Textron did not act inconsistently with the underlying purpose of keeping the documents from its potential adversary (the IRS) and thus did not waive the work-product privilege.

Observations and Recommendations

There should be a note of caution in evaluating the effect of *Textron*—the *Textron* court dealt with a pre-FIN-48 tax year. The court specifically recognized that workpapers created in the ordinary course of business are not covered by the work-product doctrine, even under the "because of litigation" standard noted above. In applying this standard, the court stated that Textron would have had no reason to establish a reserve, or to prepare workpapers, had it not anticipated a dispute with the IRS. IRS Chief Counsel Donald Korb has repeatedly stated that the *Textron* case has no application under FIN 48 tax years because of the requirement to document uncertain positions. Korb asks: How can the document be prepared in anticipation of litigation if it is required to be prepared under FIN 48? The standard for FIN 48 disclosure, however, turns on what would happen on examination of the issue, including litigation. Thus, it could be argued that all FIN 48 workpapers are attorney work-product because anticipation of litigation is an integral part of the recognition process. Nevertheless, it remains to be seen how the "anticipation of litigation" standard will be applied under the more robust financial accounting disclosure and reserve requirements of FIN 48.

There are a few key take-away observations from the *Textron* litigation. Textron's tax accrual workpapers reflected opinions and judgments of in-house and outside counsel regarding potential litigation with the IRS. The workpapers were prepared by or in conjunction with in-house and outside counsel. Also, Textron provided the documents to its auditors with an understanding that the workpapers would be kept confidential. These points were highlighted by the court in its discussion of the application of the work-product doctrine and whether it was waived.

In general, in order to strengthen an argument that the work-product doctrine applies, any documents that are prepared by or for an attorney should be labeled as confidential and either subject to the attorney-client privilege and/or the attorney work-product doctrine (as appropriate). However, in order to make sure that the privilege identification has meaning, avoid identifying a document as protected by the attorney-client privilege if it is known at the time the document is prepared that it will be disclosed to auditors (in which case the attorney-client privilege will be waived). In addition—if the document will not qualify for either privilege—a label of "confidential" is still appropriate because of the IRS' continuing policy of restraint, but the label should not include one of the privileges if it is inappropriate. There are instances when courts have required disclosure of documents that would have been otherwise privileged because of abuse in overuse of a claim for privilege.

Where it is important that documents prepared by lawyers remain confidential, the documents probably should not be included in the tax accrual workpapers or be relied upon when financial auditors examine the company's tax provision. It is possible to describe the support for a particular position, where that support is also contained in a tax opinion, for example, without

continued 24

Samuel A. Mitchell is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *smitchell@scribnerhall.com*.

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

from pg. 23

resulting in a waiver of the opinion itself. If, instead of providing the actual tax opinion, the company prepares a memo that describes the support for its position without disclosing that it has relied upon the opinion for its tax position, this is arguably not a waiver of the attorney-client privilege with respect to the opinion. Whether or not the workpapers are provided to outside auditors, also will depend on what is considered within the scope of "workpapers." The first factor is whether, on balance, there is any reason to withhold the workpapers from the auditors. There may be some instances (*e.g.*, a write-up on a well-known issue) that can be shared with auditors because there is no sensitive information in the write-up. The second factor is whether the auditors insist upon obtaining the information. For example, because the workpapers will almost certainly contain a list of all of the issues for which reserves are held and the amount of such reserves, the financial auditors may insist on obtaining this information for their audit. In such a case, there seems little choice—from a financial perspective—but to provide the workpapers to the auditors.

The question of whether documents will be protected under the work-product doctrine will come down to whether the workpapers were created as a result of the anticipation of litigation. First, the fact that the issues were identified by either the accounting or law firm as those likely to be challenged by the IRS and potentially audited should provide contemporaneous support that they are issues likely to be raised on audit and potentially leading to litigation. However, because this may not be sufficient, it may be advisable to prepare a separate memo—either by in-house or outside counsel—which describes the potential litigation risk on the various issues. This memo should not be provided to the auditors and, therefore, should remain confidential subject to the attorney-client privilege. This memorandum should be prepared contemporaneously with the workpapers (or prior thereto) to provide support for the application of the work-product privilege. Even though affidavits to this effect were successful in *Roxworthy*, contemporaneous documentation provides better support.

Finally, it is important to note that these arguments may not be sufficient to protect the document if the IRS can show sufficient cause for the production of the documents and in good faith believes: (1) the work-product sought is necessary to the determination of the taxpayer's tax liability; and (2) the information could not be obtained from any other source.[6] The IRS did not meet this burden in *Textron*.

[6] *United States v. Brown, 478 F.2d 1038 (7th Cir. 1973). See also Fed. R. Civ. P. 26(b)(3).*

Impact of Tax Return Preparer Penalties on the Insurance Industry

by John Keenan

Over the past several months, the Treasury Department (Treasury) and the Internal Revenue Service (IRS) were busy developing guidance to implement the changes made by the Small Business and Work Opportunity Tax Act of 2007[1] (the Act) to the Internal Revenue Code (Code) provisions dealing with tax return preparer penalties. On Dec. 31, 2007, the Treasury and the IRS issued a series of Notices (Notice 2008-11, Notice 2008-12 and Notice 2008-13) to provide interim guidance on the application of the tax return preparer penalties as amended by the Act, and to solicit public comments regarding the revision of the regulatory scheme governing tax return preparer penalties.

Tax professionals have been busy contemplating how the recent statutory amendments to the tax return preparer rules and the guidance found in the Notices might affect how they do business. While many tax professionals have been actively considering how the amendments might affect their practice—not to mention, the significantly increased penalty amounts—the perception is that other professionals, who would not consider themselves to be tax return preparers but who may assist tax professionals, have not been as active in the process of determining if they are subject to the section 6694 return preparer rules. This article highlights the section 6694 tax return preparer penalty regime and examines how it might potentially apply to other professionals, such as actuaries, who assist those traditionally considered to be tax professionals.

Section 6694

Background

Prior to amendment, sections 6694(a) and 6694(b) imposed penalties on income tax return preparers for certain understatements of liability on a tax return or claim for refund. In May 2007, Congress amended section 6694 to extend the application of the income tax return preparer penalties to all tax return preparers, alter the standards of conduct that must be met to avoid imposition of a return preparer penalty and increase the penalty amounts.[2]

Under amended section 6694, a paid tax return preparer could be subject to a penalty if the preparer does not have a reasonable belief that the return position for an item would more likely than not be sustained on its merits. A paid tax return preparer who does not reasonably believe a position taken on a tax return is more likely than not correct can avoid a penalty if the position is adequately disclosed.[3] Prior to the amendment of section 6694, a paid tax return preparer was not subject to a penalty if the return position satisfied the realistic possibility of success standard.[4]

The Act also significantly increased the section 6694(a) penalty. Prior to amendment, the penalty was $250. After amendment, the penalty is equal to the greater of $1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer from the preparation of the return or claim with respect to which the penalty

John R. Keenan is director, Tax Controversy Services with the Washington, D.C. National Tax office of Deloitte Tax LLP and may be reached at *jkeenan@deloitte.com*.

[1] P.L. 110-28.

[2] Small Business and Work Opportunity Act of 2007, Pub. L. No. 110-28, 121 Stat., was enacted into law on May 25, 2007. The amendments are effective for tax returns prepared after the date of the enactment, May 25, 2007. On June 11, 2007, the IRS released Notice 2007-54, 2007-27 IRB 1 (*see* § 601.601(d)(2)(ii)(b)), providing guidance and transitional relief for the return preparer provisions under amended section 6694. Notice 2007-54 provides that for income tax returns, amended returns, and refund claims, the standards set forth under section 6694 prior to amendments and current regulations under this section will be applied to all returns, amended returns, and refund claims due on or before December 31, 2007 (determined with regard to any extension of time for filing).

[3] The minimum standard for disclosed positions was also modified. For disclosed positions (*i.e.,* on a Form 8275 or 8275-R), amended IRC § 6694 replaces the non-frivolous standard with the requirement that there be at least a reasonable basis for the position.

[4] A return position is considered to have a realistic possibility of success on the merits if a reasonable and well-informed analysis by a knowledgeable tax adviser would conclude that the position has at least a one-in-three likelihood of being sustained on its merits if challenged by the IRS. Treas. Reg. § 1.6694-2(b).

continued 26

from pg. 25

is imposed.

On Dec. 31, 2007, the Treasury and the IRS issued three Notices to provide guidance on the implementation of the amendments to the tax return preparer provisions. Of particular interest for purposes of this article is Notice 2008-13, which provides guidance on (1) the relevant categories of tax returns or refund claims subject to section 6694, (2) the definition of a tax return preparer, (3) the standards of conduct applicable to tax return preparers and (4) interim penalty compliance obligations applicable to tax return preparers. This article focuses on who is considered a return preparer under this recent guidance and what activities constitute return preparation.

Definition of Tax Return Preparer

While section 6694 sets forth the penalties that can be imposed upon tax return preparers who do not meet the required return position standards, the definition of who is a tax return preparer requires one to look at section 7701(a)(36) of the Code, as well as Treas. Reg. §§ 1.6694-1, 1.6694-3, and 301.7701-15.[5]

Prior to the amendment in May 2007, section 7701(a)(36) defined *income tax return preparer* as any person who prepared for compensation an income tax return or claim for refund, or a substantial portion of an income tax return or claim for refund. The Act expanded the application of the income tax return preparer penalties to apply to all tax return preparers and is no longer limited solely to persons who prepare income tax returns. As amended, section 7701(a)(36) now defines *tax return preparer* as any person that prepares for compensation a tax return or claim for refund, or a substantial portion of a tax return or claim for refund.[6]

Notice 2008-13 advises that, until further guidance is provided, the term "tax return preparer" will be defined by utilizing current Treas. Reg. §§ 1.6694-1, 1.6694-3, and 301.7701-15 with the following modifications:

- The word "income" is eliminated as a modifier to *tax return preparer* throughout Treas. Reg. §§ 1.6694-1, 1.6694-3, and 301.7701-15.
- The definitions of returns and claims for refund from *returns of tax under subtitle A, claims for refund under subtitle A,* or similar language, is expanded to include returns of tax and claims for refund under subtitles A through E of the Code throughout Treas. Reg. §§ 1.6694-1, 1.6694-3, and 301.7701-15.

The current regulation under section 7701 defines the term income *tax return preparer* to include any person who prepares for compensation all or a substantial portion of a tax return or claim for refund.[7] By including persons who prepare a substantial portion of a tax return in the definition of tax return preparer, the regulation brings into the preparer penalty regime a wide range of activities performed by persons who do not sign the tax return or claim for refund.

---

[5] *See* Notice 2008-13.

[6] Section 7701(a)(36), as amended in May 2007, provides, in pertinent part:
In general. —The term 'tax return preparer' means any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this title or any claim for refund of tax imposed by this title. For purposes of the preceding sentence, the preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund.

[7] Treas. Reg. § 301.7701-15 Income tax return preparer.
(a) In general. An income tax return preparer is any person who prepares for compensation, or who employs (or engages) one or more persons to prepare for compensation, other than for the person, all or a substantial portion of any return of tax under Subtitle A of the Internal Revenue Code of 1954 or of any claim for refund of tax under Subtitle A of the Internal Revenue Code of 1954.
(1) A person who furnishes to a taxpayer or other preparer sufficient information and advice so that completion of the return or claim for refund is largely a mechanical or clerical matter is considered an income tax return preparer, even though that person does not actually place or review placement of information on the return or claim for refund. *See* also paragraph (b) of this section.
(2) A person who only gives advice on specific issues of law shall not be considered an income tax return preparer, unless:
(i) The advice is given with respect to events which have occurred at the time the advice is rendered and is not given with respect to the consequences of contemplated actions; and
(ii) The advice is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund. For example, if a lawyer gives an opinion on a transaction which a corporation has consummated, solely to satisfy an accountant (not at the time a preparer of the corporation's return) who is attempting to determine whether the reserve for taxes set forth in the corporation's financial statement is reasonable, the lawyer shall not be considered a tax return preparer solely by reason of rendering such opinion.

The current regulations broadly define the term *substantial portion* using a facts-and-circumstances test that compares the relative length, complexity and tax liability of a particular schedule, entry or other portion of a tax return or claim for refund to the length, complexity and tax liability of the tax return or claim for refund as a whole. However, those who do not sign the tax return or claim for refund may not have the ability to determine if the size or complexity of their work—relative to the entire tax return or claim for refund—is such that it constitutes a substantial portion of the tax return. In fact, they may have no knowledge of how their work is ultimately reported on the tax return or claim for refund.

> … whether a person is considered to be a return preparer will depend on the relative size of the deficiency attributable to the schedule. …

Under Notice 2008-13—solely for purposes of section 6694—the term *substantial portion* in § 301.7701-15(b)(1) will be interpreted to mean a schedule, entry or other portion of a tax return or claim for refund that, if adjusted or disallowed, could result in a deficiency determination (or disallowance of refund claim) that the preparer knows, or reasonably should know, is a significant portion of the tax liability reported on the tax return (or, in the case of a claim for refund, a significant portion of the tax originally reported or previously adjusted). In other words, whether a person is considered to be a return preparer will depend on the relative size of the deficiency attributable to the schedule, entry or other portion of the return prepared by that person compared to the taxpayer's correct tax liability.

"Signing Preparer" and "Nonsigning Preparer"

The regulation under section 7701(a)(36) identifies all the "income tax return preparers" of a return. The current regulations under section 6694 separate preparers into two types: "signing preparers" and "nonsigning preparers."

A "signing preparer" is any preparer who signs a return of tax or claim for refund as a preparer. A "nonsigning preparer" is any preparer who is not a signing preparer. Examples of nonsigning preparers are preparers who provide advice (written or oral) either to a taxpayer or to a preparer who is not associated with the same firm as the preparer who provides the advice.

Could an Actuary Be a Return Preparer?

Interestingly, Notice 2008-13 contains an example that is meant to demonstrate the reasonable cause and good faith exception to the imposition of a section 6694(a) penalty, but the example also sheds some light on the concept of who might be considered a nonsigning return preparer.

By way of background, a tax return preparer is not subject to a penalty under section 6694 if the preparer satisfies the reasonable cause and good faith exception. A tax return preparer will be found to have acted in good faith when the tax return preparer relied on the advice of a third party who is not in the same firm as the tax return preparer and whom the tax return preparer had reason to believe was competent to render the advice. Notice 2008-13 contains the following example of this reasonable cause and good faith exception:

> **Example 7.** In preparing a tax return, Accountant G relies on the advice of an actuary concerning the limit on deductibility under section 404(a)(1)(A) of a contribution by an employer to a qualified pension trust. The actuary providing the advice was not associated with Accountant G's firm. On the basis of this advice, Accountant G completed the tax return. It is later determined that there is an understatement of liability for tax that resulted from incorrect advice provided by the actuary. Accountant G had no reason to believe that the advice was incorrect or incomplete, and the advice appeared reasonable on its face. Accountant G was also not aware of any reason why the actuary did not know all of the relevant facts or that the advice was no longer reliable due to developments in the law since the time the advice was given. Accountant G is not subject to a penalty under section 6694.

While the example is meant to demonstrate that the accountant satisfies the reasonable cause and good faith exception to the imposition of a section 6694 penalty, it does not address whether there are any consequences to the actuary under this scenario. As discussed below, one reading of the example could be that the actuary who provided advice on the deductibility limits under section 404(a)(1)(A) is a nonsigning return preparer of the tax return prepared by Accountant G.

continued ▸▸28

from pg. 27

Remember, to be a tax return preparer under amended section 6694, the individual must have prepared, for compensation, all or a substantial portion of a tax return or claim for refund under subtitles A through E of the Code. Assuming the actuary in Example 7 was compensated by the employer claiming the deduction for its contribution to the qualified pension trust, the question that remains is whether the actuary's work constitutes a substantial portion of the tax return.

There is little in the way of guidance as to how one determines if the work performed constitutes a substantial portion of the tax return. As discussed above, the only guidance provided simply says that whether one is considered to be a return preparer will depend on the relative size of the deficiency attributable to the portion of the return prepared by that person compared to the taxpayer's correct tax liability. One could envision an argument that, under Notice 2008-13, the actuary's work would constitute a "substantial portion" of the employer's tax return if the actuary knew that the disallowance of the deduction for the contribution to the qualified pension plan could result in a deficiency that was significant in comparison to the tax liability reported on the employer's tax return. While the example does not give sufficient information to make such a determination, the example raises the possibility that under certain circumstances the actuary could be considered to be a nonsigning return preparer of the employer's return and, thus, subject to penalties under section 6694.

Standards of Conduct Applicable to Tax Return Preparers

Tax and other professionals who work with tax professionals in preparing a tax return must be cognizant of the section 6694 tax return preparer regime and the standards of conduct that must be met to avoid imposition of the penalties for preparing a return that reflects an understatement of liability.

Under amended section 6694, a tax return preparer may be subject to a penalty if the preparer does not have a reasonable belief that a position will more likely than not be sustained on its merits and the position is not adequately disclosed. Notice 2008-13 provides that a tax return preparer is considered to reasonably believe that a position is more likely than not to be sustained on its merits if the tax return preparer analyzes the pertinent facts and authorities in the manner described in §1.6662-4(d)(3)(ii) and, relying on that analysis, reasonably concludes in good faith that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS. In performing its analysis, the tax return preparer may rely in good faith and without verification on information provided by the taxpayer, another advisor or another third party. The tax return preparer, however, may not ignore the implications of information furnished to the tax return preparer or actually known to the tax return preparer. The tax return preparer also must make reasonable inquiries if the information furnished appears to be incorrect or incomplete.

Observe that the standard that applies to accuracy-related penalties for taxpayers continues to be substantial authority, as set forth in IRC section 6662. The new more-likely-than-not standard imposed on paid tax return preparers is stricter than the substantial authority standard. Thus, the modified standards place paid tax return preparers and their taxpayer clients in differing positions with respect to the imposition of accuracy-related penalties.

Interim Penalty Compliance Rules

Notice 2008-13 provides interim compliance rules on which tax return preparers can rely to avoid a penalty under section 6694(a). Tax return preparers can rely on these until further guidance is issued.

Under the interim compliance rules of Notice 2008-13, a signing tax return preparer is deemed to have met the requirements of section 6694 for positions the tax return preparer does not have a reasonable belief will more likely than not be sustained on the merits, but for which there is a reasonable basis, if the tax return preparer meets any of the following requirements:

(1) The position is disclosed in accordance with Treas. Reg. §1.6662-4(f) (*i.e.*, on a properly completed Form 8275 or Form 8275-R, or in accordance with the annual revenue procedure described in Treas. Reg. §1.6662-4(f)(2)).

(2) If the position would not meet the standard for the taxpayer to avoid penalties under section 6662(d)(2)(B) without disclosure—*i.e.*, a non-shelter position that lacks substantial authority—the signing preparer could avoid a penalty by providing the taxpayer with the prepared tax return that includes the disclosure in accordance with Treas. Reg. § 1.6662-4(f).

(3) If the position would otherwise meet the taxpayer's requirement for nondisclosure under section 6662(d)(2)(B)(i)—*i.e.,* a non-shelter position supported by substantial authority—the signing preparer could avoid a penalty by (a) advising the taxpayer of the difference between the penalty standards applicable to the taxpayer under section 6662 and those applicable to the tax return preparer under section 6694, and (b) contemporaneously documenting in the signing preparer's files that this advice was provided.

(4) If section 6662(d)(2)(B) does not apply because the position may be described in section 6662(d)(2)(C)—*i.e.,* a tax shelter position—the signing preparer could avoid a penalty by (a) advising the taxpayer of the penalty standards applicable to the taxpayer under section 6662(d)(2)(C) and the difference, if any, between those standards and the standards under section 6694, and (b) contemporaneously documenting in the signing preparer's files that this advice was provided.

A nonsigning tax return preparer is deemed to have met the requirements of section 6694 for positions for which the tax return preparer does not have a reasonable belief that the position will more likely than not be sustained on the merits, but for which there is a reasonable basis if the nonsigning tax return preparer meets the following requirements:

(1) *Advice to taxpayers.* The nonsigning tax return preparer can avoid a penalty by (a) including with the advice a statement informing the taxpayer of any opportunity to avoid penalties under section 6662 that could apply to the position as a result of disclosure, if relevant, and the requirements for disclosure, and (b) contemporaneously documenting in the preparer's file that the statements were given.

(2) *Advice to other preparers*. The nonsigning tax return preparer can avoid a penalty by (a) including with the advice a statement that disclosure under section 6694(a) may be required, and (b) contemporaneously documenting in the preparer's file that the statements were given.

Determining whether a person qualifies as a "return preparer" is not necessarily a simple undertaking. …

(3) *Format of required statements.* The statements referred to above must be in writing if the advice was in writing, but may be oral if the advice was oral.

Conclusion

Determining whether a person qualifies as a "return preparer" is not necessarily a simple undertaking for those individuals who have only provided advice to a taxpayer and have not physically completed the taxpayer's tax return. As the exposure to penalties for tax return preparers has increased as a result of the Act's changes to the standards required to avoid a penalty—as well as the amount of the penalty that could potentially be imposed—professionals who would not consider themselves to be tax return preparers, but who may assist tax professionals, must be aware of the section 6694 tax return preparer regime. These professionals should take steps to ensure they are complying with the standards of conduct that must be met to avoid imposition of penalties.

This article does not constitute tax, legal or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal or other consequences arising from the reader's particular situation.

Editor's Note: Recently, there has been a movement to pass additional legislation dealing with the standards applicable to return penalties for taxpayers and preparers. Any further developments on this issue will be discussed in an upcoming edition of *Taxing Times*.

Identified Straddle Rules Fixed by Technical Corrections

by Biruta P. Kelly and Peter H. Winslow

The recent technical corrections legislation signed into law on Dec. 29, 2007, the Tax Technical Corrections Act of 2007, Pub. L. 110-172, contains a provision that improves the identified straddle rules. The identified straddle rule of section 1092(a)(2) permits a taxpayer to select positions in a straddle and thereby avoid surprise applications of the straddle rules by the IRS on audit.

Biruta P. Kelly is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *bkelly@scribnerhall.com*.

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

Background—The Basic Straddle Rules

The basic thrust of the section 1092 straddle rules is to defer the recognition of losses on positions in a straddle where the taxpayer continues to hold gain positions of the straddle that were offsetting to the loss positions. Offsetting positions result where a taxpayer has a substantial diminution of risk of loss in personal property by reason of the holding of one or more other positions (*i.e.,* a hedge). Where a company may have numerous offsetting positions, it is useful to be able to identify the offsetting positions in a straddle to ensure the application of the loss deferral rules will be as anticipated. Otherwise, insurance companies could find themselves in a difficult position upon an IRS examination where they sold derivatives at a loss. For example, the IRS could take the position on audit that a short position is a straddle with the company's entire bond portfolio, and thereby attempt to disallow the loss "permanently" as long as there was unrecognized gain in the company's bonds. The IRS could adopt this position even though the offsetting positions were "unbalanced," *i.e.,* where the derivative positions were small as compared to the entire bond portfolio.

Although the straddle rules as originally enacted in 1981 contained a provision that allowed taxpayers to identify positions in a straddle, it was not a practical solution. This is because the provision applied only where all the positions of the straddle were acquired on the same day and they had to be disposed of on the same day. Due to these practical limitations, the identified straddle rules were not used. Instead, taxpayers resorted to "self-help" identification for hedges of capital assets that do not qualify for the tax hedging exception from the straddle rules. Support for the self-help approach could be found in PLR 199925044 (June 28, 1999), where the IRS National Office stated that in the absence of regulations providing rules for dealing with unbalanced positions under section 1092(c)(2)(B), it was permissible for taxpayers to identify shares of stock that were part of a straddle. However, with these type of self-help attempts, there was no certainty that such identification would be respected by the IRS, or apply more broadly to other types of straddles.

2004 Legislative Changes to Straddle Rules

Because of the identification problems and threat of a permanent disallowance on audit, taxpayers—including life insurance companies—approached Congress for a change in the identification rules. In response to these requests, in 2004, the identified straddle rules were modified to permit identification of any straddle as long as it was made before the close of the day on which the straddle was created. The 2004 legislation also changed the operation of the recognition of straddle losses with respect to identified straddles. Normally a straddle loss is disallowed under section 1092(a) only to the extent of the unrecognized gain in the offsetting positions. This means that the loss is recognized without the disposition of the offsetting position, so long as the loss exceeds the amount of unrecognized gain in the offsetting positions at the close of the year. In 2004, the new identified straddle rules adopted a different rule for recognition of losses in the identified straddle:

> [I]f there is any loss with respect to any identified position of the identified straddle, the basis of each of the identified offsetting positions in the identified straddle shall be increased by an amount which bears the same ratio to the loss as the unrecognized gain with respect to such offsetting position bears to the aggregate unrecognized gain with respect to all such offsetting positions.

This rule posed a technical issue where there was no unrecognized gain in the offsetting positions. Potentially, the loss could be disallowed permanently under the literal statutory language because the loss is allowed to be taken *only* under the straddle rules and otherwise is specifically disallowed.

2007 Technical Corrections

The 2007 technical corrections legislation fixed this problem to clarify that the loss will not be permanently disallowed. Consequently, with this clarification, the identified straddle rules are now useful to ameliorate audit risk for hedges of capital assets. To take advantage of the identified straddle provision, a taxpayer first must identify a hedge as an identified straddle before the close of the day the position in the straddle is acquired. However, there are two basic limitations to the positions that may be identified: (1) to the extent provided in regulations, a position cannot have an inherent loss (*i.e.,* value is no less than basis) and (2) the positions in the straddle cannot be part of a larger straddle.

Once a straddle is identified by the taxpayer, a loss on the disposition of a position in the identified straddle is added to the basis of the offsetting positions by an amount that bears the same ratio to the loss as the unrecognized gain in the offsetting position bears to the unrecognized gain in all offsetting positions. The technical corrections added a clarification to address the situation where there may be no gain in the offsetting positions: if the application of the allocation rule would not result in an increase in basis, the basis of each of the offsetting positions in the identified straddle shall be increased in a reasonable, consistently applied manner.

Identified Straddles Versus Integrated Transactions

In certain situations, taxpayers may have a choice whether to identify a transaction as an identified straddle under section 1092(a)(2) or an integrated transaction under Treas. Reg. § 1.1275-6, or, in appropriate instances where foreign assets or liabilities are involved, under Treas. Reg. § 1.988-5. The overlap exists in the situation where the derivative is used to create a synthetic debt instrument. For example, a swap could be used to turn a floating rate debt instrument into a fixed rate debt instrument. In this case a taxpayer could identify the transaction under Treas. Reg. § 1.1275-6 as integrated resulting in a synthetic fixed rate bond or use the identified straddle rules under section 1092(a)(2). In the former situation, for tax purposes, the taxpayer would be treated as having a single debt instrument. If the taxpayer disposed of the derivative while retaining the original debt instrument, the Treas. Reg.

With this clarification, the identified straddle rules should be considered in any situation involving a hedge of a capital asset.

§ 1.1275-6(d)(2) legging out rules would apply, causing a deemed disposition of the synthetic asset, which would result in the offsetting gain and loss being recognized currently and a basis adjustment to the continuing debt instrument. If there were unhedged embedded gain or loss in the debt instrument—as in the situation of credit risk, for example—it would be recognized in the deemed disposition. On the other hand, if the identified straddle rules were used, and the taxpayer disposed of the derivative while retaining the original debt instrument, gain, but not loss, would be recognized currently. A loss would be added to the basis of the outstanding debt instrument. Gain, on the other hand, would be recognized even though the gain hedged an offsetting loss in the debt instrument.

Because of the one-way nature of the straddle rules—in cases of overlap—it may be preferable to use the integration rules, where applicable. It should be noted that the identified straddle rule is not available in a situation to which the tax hedging rules are applicable. *E.g.,* section 1092(e) (Treas. Reg. §§ 1.1221-2 and 1.446-4, *i.e.,* certain hedges of ordinary property or ordinary obligations.)

Conclusion

The technical corrections legislation provided a much-needed solution to a significant problem for life insurance companies. With this clarification, the identified straddle rules should be considered in any situation involving a hedge of a capital asset. Preliminary indications are that life insurance companies will use the identified straddle rule extensively to avoid uncertainty and ensure that on examination the IRS will not attribute a loss on derivatives to unidentified assets, or, worse, to the entire bond portfolio. It should be particularly useful for derivatives designated as highly effective asset hedges for GAAP and statutory accounting purposes. In such cases, the identified straddle rules can ameliorate the audit risk for hedges of capital assets.

ACLI Update Column

by Mandana Parsazad

In January 2008, the American Council of Life Insurers (ACLI) had the exceptional opportunity to be informed in advance of the preliminary findings the Treasury Department (Treasury) and the Internal Revenue Service (IRS) have made in their project to improve and simplify the correction procedures for life insurance and annuity contracts that have failed the requirements of the Internal Revenue Code (the Code). In sharing their proposed course of action with the ACLI, Treasury and IRS officials noted the extraordinary coordination between the government and the life insurance industry in this project. The ACLI and its members agree—the life insurance industry viewed this project as an opportunity to brief Treasury and IRS on the practical complexities of tax compliance for life insurance and annuity contracts and is pleased that many of its concerns with existing procedures are being addressed.

Our dialogue—as well as the relief Treasury and IRS have informally outlined to us—confirm the government heard that the industry has every interest in keeping its life insurance and annuity contracts in compliance with the requirements of the Code.

This project began last year when Treasury and IRS issued Notice 2007-15 (Notice) in January 2007, seeking input on how the procedures for correcting life insurance contracts failures might be improved. The ACLI submitted comments suggesting comprehensive changes to the current procedures by which the IRS permits life insurers to correct life insurance and annuity contracts that have failed to meet the technical requirements of the Code. Specifically, we suggested:

Mandana Parsazad is tax counsel at the ACLI in Washington, D.C. and may be reached at *MandanaParsazad@acli.com*.

(1) The procedure for obtaining waivers under section 7702(f)(8) for failures of life insurance contracts to satisfy section 7702 that the Treasury and IRS determine to be "reasonable" could be streamlined and made automatic in cases where contract failures occur for reasons that the IRS has repeatedly deemed to be reasonable;

(2) Toll charges for section 7702, 7702A and section 817(h) failures could be determined more simply and in a manner that would more directly reflect the seriousness and magnitude of the errors for which correction is sought; and

(3) The closing agreement procedure for life insurance contracts that inadvertently become modified endowment contracts (MECs) would be less burdensome, without affecting the integrity of the closing agreement process, if applicants for closing agreements were required to submit substantially less information than is currently required by Rev. Proc. 2001-42.

In our subsequent meetings and submissions, we raised critical tax policy reasons for the changes we recommended and underscored the compelling non-tax reasons underlying life insurance companies' commitment towards their compliance obligations. These discussions helped inform Treasury and IRS that life insurance companies have compelling reasons to safeguard the good reputation of their life insurance and annuity products to remain competitive in the marketplace. We also highlighted that state insurance regulation, consumer lawsuits and, in the case of variable contracts, securities laws impose sanctions on companies that do not comply with the law. Our continuing open dialogue with Treasury and IRS forged a relationship of trust on this project that contributed to guidance that we expect will result in more efficient use of IRS personnel as well as life insurance and annuity contract compliance resources.

The ACLI looks forward to the release of guidance on life insurance and annuity contract corrections procedures and continuing to work cooperatively with the Treasury and IRS on similar issues in the future.

T³: Taxing Times Tidbits

Exchange of BOLI Policies Under Section 1035
by Christian DesRochers

In a recently-released letter ruling, PLR 200801001, the IRS described circumstances under which a taxpayer was permitted to exchange general account BOLI (Business Owned Life Insurance) policies for separate account policies on the same insureds. Under the facts of the ruling, the taxpayer owned both group certificates and individual policies. The group certificates were treated as separate contracts under section 264(f)(4)(E) for purposes of sections 7702 and 7702A, and were all modified endowments under 7702A. The group certificates were to be exchanged for certificates under a variable life group policy, while the individual policies were to be exchanged for individual variable life policies. No changes in face amount would be made except as needed to qualify the new policies under section 7702. There were no policy loans—either currently or in the past—and no surrender or distributions from the policies would be made at the time of the exchange from either the existing or new policies. All of the policies to be exchanged were on currently active employees, and all had given written permission for the new coverage.

The IRS noted that "Taxpayer represents that the certificates issued for a single insured pursuant to a group account BOLI policy are treated as separate contracts for purposes of state insurance laws, and that Taxpayer does treat each certificate as a separate contract for purposes of 817(h), 7702, and 7702A." The taxpayer also represented "in its proposed exchanges, it will not make any material increase in the death benefit or any material change." Commenting that the newly-issued policies would be modified endowment contracts (MECs) by virtue of being exchanged for MECs, the IRS ruled that the proposed exchange would meet the requirements of section 1035(a)(1), and that the basis and the investment in the contract of the newly issued contracts would be the same as that of the contracts for which they were exchanged.

The letter ruling describes a narrow set of circumstances under which a tax-free exchange was recognized, and verifies circumstances under which group certificates are treated as individual contracts. What may be more interesting are the issues not addressed. Does the comment that the BOLI group certificates are treated as separate contracts "under state law" apply in the case of an experience-rated contract? Is the characterization critical to the outcome, or is the treatment under 7702, 7702A and 817(h) controlling? As the exchange only involved active employees, does the employee exception under section 264(f)(4)(A) "at the time first employed covered under the policy or contract" carry forward in an exchange for terminated or retired employees?

Christian DesRochers, FSA, MAAA, is a senior managing director, Life Actuarial Services with SMART Business Advisory and Consulting and may be reached at *cdesrochers@smartgrp.com*.

The NAIC and Tax Concerns from the Implementation of the PBR Methodology
by Emanuel Burstein

An especially difficult tax problem arising from the implementation of a principle-based approach to computing statutory reserves is how to ensure that reserves for products, such as traditional life insurance, would continue to qualify as life insurance reserves under section 816(b).[1] One way to address these concerns would be for the National Association of Insurance Commissioners (NAIC) to work with Treasury officials and insurance company representatives to structure a discrete

[1] The tax consequences of implementing principle-based reserving is addressed in E. Burstein, *The Tax Consequences of Statutory Principles-Based Reserves Valuation* [hereinafter cited as *Burstein analysis*], which is available on-line at http://insurancetax.com/Special-Documents/PrinciplesBasedReserves2.pdf.

continued 34

from pg. 33

Emanuel Burstein is the author of *Federal Income Taxation of Insurance Companies* and he may be reached at *manny@insurancetax.com.*

component of principle-based reserves to conform to the technical requirements of a life insurance reserve under section 816(b). The remainder of the principle-based reserve would be taken into account as an additional (statutory) reserve, which would be treated as an excess (solvency) reserve for tax purposes.

Under section 816(b), a statutory reserve qualifies as a life insurance tax reserve if it satisfies a set of specified requirements.[2] The reserve must be based on prescribed interest rates and mortality (or morbidity) factors. Although the Service argued that using factors such as lapse rates to value a reserve precludes the reserve from qualifying as a life insurance (tax) reserve, it appears that the Service will conclude that "non-mortality" factors can be used to determine life insurance reserves if the estimates of these factors are reasonable.[3] A life insurance reserve also must be "set aside to mature or liquidate" future unaccrued claims from specified types of life insurance, annuity and long-term accident and health insurance coverage. It cannot cover general insurance company expenses so that a component of a principle-based reserve that satisfies section 816(b) cannot include an amount that covers these expenses.

Treating a component of a principle-based reserve that qualifies as a life insurance reserve under section 816(b) addresses the Service's concern whether a principle-based reserve would qualify, at least in part, as a life insurance reserve for tax purposes.[4] It also addresses Service concerns regarding the valuation of interest and mortality factors that a life insurer can use to compute life insurance tax reserves under section 807(d).[5] The principle-based reserving approach would have tax consequences that the Service could readily administer, which is another important goal of the Service.[6]

The NAIC has demonstrated that it is sensitive to the concerns of insurance companies and the Treasury Department. In the 1940s, Treasury officials were concerned that using statutory accounting rules for unpaid losses of property and casualty insurance companies distorted the taxable income of certain insurers. The unpaid loss reserves were based on the value of an item in the annual statement of an insurer, which equaled the greater of case reserves or the Schedule P amount. Case reserves were based on the valuation of specific claims. The Schedule P amount was determined under a formula, which was not based on the amounts that the company set aside to cover events that triggered liability.

The Treasury was concerned that some insurers might apply the excess Schedule P amount and overstate unpaid loss tax reserves in response to court decisions, such as the First Circuit's holding in *New Hampshire Fire Ins. Co. v. Commissioner*[7] that tax accounting rules for a property and casualty insurer follow the treatment for an item in its annual statement. The Tax Court applied these principles to allow a property and casualty insurer to use the value of its unpaid loss reserves reported in its annual statement for liability and workers compensation coverage for tax purposes in *Columbia Casualty Ins. Co. v. Commissioner.*[8] The Service assessed deficiencies on taxpayers that attempted to deduct tax reserve increases attributable to excess Schedule P amounts.

The NAIC addressed the Treasury's concerns by revising the statutory accounting rules. Under the new rules, an insurance company's statutory income continued to be influenced by a change in the insurer's case reserves, but a change in the insurer's excess Schedule P losses adjusted its surplus.[9] Consequently, only changes in an insurer's case reserves influenced the value of its unpaid losses for tax purposes. One commentator noted that the "changes produce[d] a more realistic picture of operations for the year without in any way distorting the financial condition of a company as measured by the statutory requirements."[10]

The adjustment in the NAIC's accounting rules clarified that unpaid loss adjustments attributable to excess Schedule P amounts cannot be applied by property and casualty insurers for tax purposes. In addition, under current law, a property and casualty company can take only "fair and reasonable" estimates of (allowable) un-

2 Section 816(b) is addressed in detail at E. Burstein, *Federal Income Taxation of Insurance Companies* (2nd ed.) at 168-186 (2007).
3 *See Burstein analysis* at 6-8.
4 *See* Notice 2008-18, section 3, 2008-5 I.R.B. 363, 364.
5 *Id.* at sections 3.04 and 3.05, 2008-5 I.R.B. 363, 365.
6 *Id.* at section 3.08, 2008-5 I.R.B. 363, 365.
7 146 F.2d 697 (1st Cir. 1945).
8 7 T.C.M. 282 at 285-286 (1948).
9 These developments are addressed in Tye, C., "The Convention Form and Insurance Company Tax Problems," 6 *Tax Law Review* 245 (1951).
10 *Id.* at 252.

paid loss reserves into account for tax purposes under Treasury Regulation section 1.832-4-(b), which are discounted under section 846.

The industry and insurance regulators may have to recognize the tradeoff between a theoretically pure statutory principle-based reserving approach that is not easily applied in practice and an approach that is not theoretically pure but can be applied to value reserves by insurance companies and administered by insurance regulators. One benefit of the latter, practical, approach is that it can address important tax policy goals. It can include a discrete component that qualifies as a life insurance reserve under section 816(b) that (1) addresses the underlying intent of Congress, (2) can be applied by insurance companies and (3) can be administered by the Service. The NAIC demonstrated that it was sensitive to Treasury Department concerns regarding the impact of statutory accounting rules in the late 1940s and can do so again by issuing principle-based reserving rules that address related Treasury Department concerns.

New Whistleblower Law Generating Very Large Claims

by Samuel A. Mitchell

For many years the IRS has had the legal authority to award money to whistleblowers who provide information resulting in the collection of underpaid taxes. However, in the past, the IRS had complete discretion over the awards and did not effectively administer the process.[1] As a result, the old program—if one could call it a program—generally did not result in significant awards and did not draw much attention from taxpayers or practitioners. All of that changed on Dec. 20, 2006, with the passage of the Tax Relief and Health Care Act of 2006.[2] The Act creates a special Whistleblower Office within the IRS to administer claims and requires the IRS to make a whistleblower award—under certain circumstances—of at least 15 percent and up to 30 percent of the underpaid taxes, penalties and interest the IRS ultimately collects through administrative or judicial action it takes based on information provided by a whistleblower.

The required awards apply only in cases where the taxes, penalties and interest in dispute exceed $2,000,000, and, in an action against an individual taxpayer, where the offending taxpayer's gross income exceeds $200,000. The amount of the award (15 to 30 percent of the taxes, penalties and interest collected) depends on the extent to which the Whistleblower Office determines that the whistleblower "substantially contributed" to action against the offending taxpayer, and the Whistleblower Office's determination is subject to an appeal to the Tax Court.[3] The Act requires the IRS to issue regulatory guidance regarding the process and the standards the Office of Whistleblower will use in administering the new program. Recently the IRS issued interim guidance in the form of Notice 2008-4. The Notice restates the provisions in the Act, provides specific guidance on what information a whistleblower is required to file, and clarifies that the IRS will attempt to keep the whistleblower's identity confidential but cannot promise to do so in all cases.

Significantly, the Notice also clarifies that the awards are available even if an audit of the taxpayer is already underway. As an example, the Notice explains that the Whistleblower Office may approve an award if the information results in a new issue on the audit plan of a large-case taxpayer under audit or if the information results in a change in the way information about an existing issue is collected or analyzed that would not otherwise have occurred absent the information. In this context, it is important to note that even people who initiated or planned the actions that led to the underpayment of tax are eligible for the award. It is clear that such people are eligible for the award because the Act allows the Whistleblower Office to reduce the award paid to any such person.[4] Thus, tax managers, tax employees, investment

Significantly, the Notice also clarifies that the awards are available even if an audit of the taxpayer is already underway.

Samuel A. Mitchell is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *smitchell@scribnerhall.com.*

1 *See* former I.R.C. § 7623, providing for an award at the discretion of the Secretary, and Procedural Regulation § 301.7623-1, providing that an IRS district or service center director has the authority to "approve a reward, in a suitable amount . . . ."

2 Pub. L. No. 109-432.

3 Awards are available for lesser amounts under the old system of complete discretion. *See* Notice 2008-4, 2008-2 I.R.B. 253 (Dec.19, 2007). Moreover, similar discretionary awards are available under the new provision for less than a "substantial contribution," but not in excess of 10 percent of the unpaid taxes, interest and penalties. *Id.*

4 If the person is convicted of a crime arising from the role in initiating or planning the action, the Whistleblower Office is required to deny the award.

continued 36

from pg. 35

bankers, accountants and others could conceivably collect awards (albeit reduced awards) under the program even if they participated in the planning or initiation of actions that led to the underpayment.

FIN-48 and the IRS' war on tax shelters have resulted in renewed scrutiny on tax departments and on the positions large corporate taxpayers report on their returns. The whistleblower provision will only increase that scrutiny and create another, perhaps even more significant deterrent for corporations tempted to take aggressive tax positions on their returns. There is no doubt that the new law's generous provisions will result in very large claims against corporate taxpayers, and lawyers are lining up to represent claimants. Indeed, one whistleblower firm with offices in Washington D.C. has announced that it has filed claims involving $4 billion in taxes, penalties and interest in the year since the law was enacted. The firm's latest claim reportedly involved $600 million. Even after a substantial contingency fee, a possible 30-percent recovery on $600 million would be very tempting even to the most loyal employee.

Section 338 Insurance Company Regulations Finalized

by Lori J. Jones and Mark H. Kovey

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

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

The IRS has finalized the last package of regulations dealing with taxable acquisitions and dispositions of insurance businesses under section 1060 and pursuant to section 338 elections. The final regulations did not make any major changes to the proposed regulations, adopting an assumption reinsurance model for the transfer of an insurance business pursuant to a section 338 deemed asset sale. The final regulations also retain the distinction between acquisitions of insurance businesses which are subject to section 1060 (assumption reinsurance or indemnity reinsurance transactions) because they involve the acquisition of a significant business asset versus mere reinsurance which continues to be subject only to the principles under Treas. Reg. § 1.817-4(d).

Specifically, in T.D. 9377, published on Jan. 22, 2008, the IRS finalized proposed and temporary regulations under sections 197, 338, 381 and 846 primarily without change. All of the regulations apply to transactions that occur on or after April 10, 2006 when the rest of the related regulations were finalized. This new set of final regulations deals with situations where the proposed regulations (originally issued on March 8, 2002) were modified as a result of comments. Specifically, the newly finalized regulations include Treas. Reg. § 1.197-2(g)(5)(ii) which provides guidance on the interplay between section 197(f)(5) (generally requiring capitalization of a ceding commission in an assumption reinsurance transaction in excess of the section 848 amortization) and section 848 (requiring capitalization of specified policy acquisition expenses). Treas. Reg. § 1.338-11(d) deals with reserve increases by new target after the deemed asset sale pursuant to a section 338 election or the actual asset sale subject to section 1060. Treas. Reg. § 1.381(c)(22)-1 amends Example 3 by correcting a mathematical error. Finally, Treas. Reg. § 1.846-4 lists a section 338 election as an event pursuant to which a company can make a section 846(e) election (if the qualified stock purchase is made on or after April 10, 2006).

IRS Withdraws Proposed Captive Insurance Regulations

by Frederic J. (Rick) Gelfond and Yvonne S. Fujimoto

On Feb. 20, 2008, the IRS announced that it withdrew the portion of its Sept. 27, 2007, proposed regulations (REG 107592-00) that would have eliminated the ability of certain domestic captive insurance companies to currently deduct their loss reserves relating to insurance covering members of the captive's consolidated group. [*See* proposed regulations section 1.1502-13(e)(2)(ii)(C).] The proposed regulations were an unexpected development that was met with strong efforts by many states and captive insurance industry providers to have the proposed regulations withdrawn. Among the major concerns expressed to the IRS were:

- The approach of the insurance provisions contained in Subchapter L of the Internal Revenue Code, which the proposed regulations would have effectively negated, more clearly reflects income.
- The proposed regulations are contrary to a long history of case law and the IRS's own revenue rulings that respect the insurance tax treatment of transactions in a captive insurance scenario.
- Because the proposed regulations only applied to domestic consolidated groups, the practical impact of adoption would have been to cause many groups to move their captive insurance companies offshore. As a result, foreign domiciles for captives would have benefited to the detriment of many domestic state domiciles that depend on revenue from captives and the generation of jobs related to the captive industry.

Had the proposed regulations been adopted, it is likely that many taxpayers would have been required to change the way they account for intercompany insurance transactions for federal income tax purposes. The proposed regulations required consolidated groups with a captive insurance company to account for their intercompany insurance transactions on a single-entity basis, eliminating the application of the unique insurance tax provisions, such as a deduction for discounted unpaid loss reserves and unearned premium reserves. Essentially, the proposed regulations would have resulted in many intercompany insurance transactions being treated in a manner comparable to self-insurance by a single corporation.

Kudos to the IRS for listening to, and acting upon, serious concerns raised by both taxpayers and other interested parties.

This article does not constitute tax, legal or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal or other consequences arising from the reader's particular situation.

Protected Cells As Insurance Companies

by Mark H. Kovey

The Internal Revenue Service (IRS) issued guidance—and requested comments for use in issuing further guidance—on the standards for determining whether insurance or reinsurance arrangements entered into with protected cell companies (Cell Companies) constitute insurance for federal income tax purposes and whether a protected cell is an insurance company (separate from the Cell Company that establishes the Cell). The characteristics of Cell Companies are described below. *See* Rev. Rul. 2008-8, 2008-5 I.R.B. 340 and Notice 2008-19, 2008-5 I.R.B. 366. Until this publication, there was no guidance on these tax issues, although the IRS had requested comments on captive cell arrangements in Notice 2005-49, 2005-2 C.B. 14. Guidance adopted pursuant to the Notice is to be effective for the first taxable year beginning more than 12 months after the date the guidance is published in final form.

Overview

The issues are important in the insurance world because Cell Companies are being used in many arrangements such as wholly-owned captives, rent-a-captives and life insurance securitizations where the Cell is designed to receive insurance or reinsurance risk. Outside the insurance industry, Cells and Cell Companies have become fashionable in structured finance and other securitization transactions. Cell Companies are known by other names, including segregated portfolio companies, series companies and segregated account companies. Cells are useful as a method of segregating or isolating risk; by statutes Cells' net assets are protected for most commercial purposes from the creditors of other Cells or of the Cell Company.

Cell Companies are known by other names, including segregated portfolio companies, series companies and segregated account companies.

The essential characteristics of most Cell Companies are:

- The governing state law authorizes the Cell Company to create Cells.
- Each Cell has its own assets and liabilities.
- Creditors of one Cell cannot reach assets of another Cell.
- Each Cell has its own owners, at least of preferred interests.

In the insurance industry, the two most important and basic tax questions have been whether the Cell is a separate taxpayer from the Cell Company, and how to test if the Cell has received insurance risk under the traditional approach of the tax law that requires a finding of a shifting and distribution of insurance risk.

Rev. Rul. 2008-8: When Do Captive Cells Receive Insurance Risk?

Rev. Rul. 2008-8 deals only with the second question and discusses it in the context of captive insurance. It describes a Cell Company formed by a "sponsor" under a typical state protected cell statute, where the sponsor owns all of the common stock of the Cell Company. The ruling describes two Cells created by the Cell Company. One Cell exclusively covers professional liability risks of a single taxpayer that owns all the preferred stock in the Cell (a parent-subsidiary captive insurance situ-

continued 38

Rick Gelfond is a principal with the Washington, D.C. National Tax office of Deloitte Tax LLP and may be reached at *fgelfond@deloitte.com*.

Yvonne S. Fujimoto is insurance tax manager with the Washington, D.C. National Tax office of Deloitte Tax LLP and may be reached at *yfujimoto@deloitte.com*.

from pg. 37

ation). The other Cell covers risks of 12 separate subsidiaries commonly owned by the owner of that Cell's preferred stock (a brother-sister insurance situation). The professional services rendered by each of the subsidiaries are the same, so that together the 12 subsidiaries have a significant volume of independent, homogeneous professional liability risks. None of the subsidiaries provides less than 5 percent, nor more than 15 percent of the total risk insured by the Cell. The amounts charged the insureds in both cases as premiums under the annual arrangements are established according to customary industry rating formulas. In all respects, the Cells and the insureds conduct themselves consistently with the standards applicable to an insurance arrangement between unrelated parties. The fact patterns are like those described in Rev. Ruls. 2002-89 (2002-2 C.B. 984) and 2002-90 (2002-2 C.B. 985), and the IRS reaches the same conclusions it reached there on what constitutes insurance with the Cells.

The professional services rendered by each of the subsidiaries are the same, so that together the 12 subsidiaries have a significant volume of independent, homogeneous professional liability risks.

In summary, Rev. Rul. 2008-8 states that the same principles apply to determine the insurance status of a Cell arrangement as apply in determining the status of an arrangement with any other insurer, including a separately incorporated insurance company. Therefore, under the facts and circumstances detailed in the ruling, the parent-subsidiary single insured relationship is held not to qualify as insurance for federal income tax purposes, while the brother-sister multi-insured situation is found to be insurance. The ruling makes no finding that the brother-sister multi-insured Cell is a separate taxpayer, but that clearly is the case under the IRS' own standards, and the Notice provides the requirements for making such a finding.

Notice 2008-19: When is a Protected Cell an Insurance Company?

Notice 2008-19 announces proposed guidance on treating a Cell separate from its Cell Company that, when issued, may take the form of a regulation, ruling, etc. The proposed guidance would include a rule to the effect that a Cell of a Cell Company would be treated as an insurance company separate from any other entity if two requirements are met. First, the assets and liabilities of the Cell are segregated from the assets and liabilities of any other Cell and from the assets and liabilities of the Cell Company, such that no creditor of any other Cell or of the Cell Company may look to the assets of the Cell for the satisfaction of any liabilities, including insurance claims (except to the extent that any other Cell or the Cell Company has a direct creditor claim against such Cell). The second requirement is that—based on all the facts and circumstances—the arrangements and other activities of the Cell, if conducted by a corporation, would result in its being classified as an insurance company within the meaning of I.R.C. § 816(a) or 831(c).

The proposed guidance also would state some of the consequences of the Cell's status as a separate insurance company, including that the Cell obtain a separate EIN, and that it (not the Cell Company) make tax elections (except in certain circumstances where the common parent of a consolidated group makes the elections). Notice 2008-19 also provides that the Cell's activities would be disregarded when determining the status of the Cell Company as an insurance company. Likewise, the proposed guidance would provide that the Cell Company would not take into account any items of income, deduction, reserve or credit for any Cell treated as an insurance company.

Notice 2008-19 also requests comments on various matters, including appropriate transition rules when a Cell Company qualifies as an insurance company for some years and not for others, the need for special rules for foreign corporations, and the need for guidance on treatment of Cells in consolidated returns. Guidance in fact is needed on these and many more issues. For example, the Notice warns against forming any negative inferences from the proposed guidance so that no conclusions should be inferred as to the treatment of a Cell that does not meet the proposed test. Parties that have taken the opposite position (namely, that all of the Cells are part of one taxpayer, the Cell Company) will have their own questions. Questions also will arise about the treatment of a Cell under the life-nonlife consolidated return waiting period rules, mergers of Cells, disregarded entity status of Cell Companies that own Cells treated as separate insurance companies, and so forth. Comments are due by May 5, 2008.

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

Note from the Editor

The Editorial Staff of *Taxing Times* shared with representatives from the Pre-Need Segment of the life insurance industry an advanced copy of the article included in this issue of *Taxing Times* titled, "NAIC Proposal for Mortality Under Pre-Need Life Insurance." Several events occurred subsequent to the drafting of this article, most notably, the NAIC Plenary adopted the NAIC Model Regulation on March 31, 2008. The Pre-Need industry is hoping that states will be expeditious in adopting the Model Regulation, with expectations that 26 states will adopt the Model Regulation by the end of this year.

In reviewing the article, representatives from the Pre-Need industry expressed an interest in providing commentary in this issue of *Taxing Times*. Because of the importance of this Model Regulation to Pre-Need writers, and the desire for states to move quickly on the adoption process, *Taxing Times* felt that it was appropriate to allow representatives from the Pre-Need industry to submit a "Letter to the Editor" which follows. I would like to thank the Taxation Section Council, the Editorial Board and the staff at the Society of Actuaries for the time and effort needed to make this happen.

I hope you enjoy this issue of *Taxing Times.*

Brian King

Dear Mr. King:

We represent most of the country's preneed insurers with regard to the implications of the Model Regulation discussed in your upcoming article *NAIC Proposal for Mortality under Pre-need Life Insurance.* We have reviewed an advance copy of that article, and greatly appreciate the opportunity you have extended allowing us to respond to certain points raised in the article, and for your offer to include this letter as an insert in the May issue of *Taxing Times.*

Certain points discussed in the article may cause some readers to misinterpret the tax and legal implications of the Model Regulation's adoption. Industry representatives have discussed those matters with you, and we are encouraged to learn that *Taxing Times* neither intends for its article to impose harm upon companies writing preneed insurance, nor does it intend to advocate any position with respect to the points its article raises.

Our clients have a concern with the article's suggestion that even if adopted by 26 states the 1980 CSO may not be considered the prevailing commissioners' standard table (during the Section 807(d)(5)(B) transition period) because it is not the most recently developed table. While it is true that the 2001 CSO is the most recently developed table, for purposes of Section 807 it is not the most recently adopted table. This distinction is of critical importance to the preneed insurance industry.

Under Section 807(d)(5)(A), the term "prevailing commissioners' standard table" means, with respect to any contract, the most recent table prescribed by the NAIC and permitted by 26 states. The Model Regulation sets forth that it applies to a particular type of contract, a life insurance policy used to fund a preneed agreement. The Model Regulation was unanimously adopted by the NAIC, and is currently before the states. Once permitted by 26 states, the 1980 CSO will become the "new" prevailing commissioners' standard table for policies funding preneed agreements. At that same time, the 2001 CSO will become the prior-prevailing commissioners' standard table for those policies. Because a change in tables will have occurred, under Section 807(d)(5)(B) either CSO may be used during the three year transition period and reserves calculated under either CSO will remain fully tax-deductible.

Our clients are pleased the article recognizes that if the Model Regulation is permitted by 26 states, the 1980 CSO will constitute the prevailing commissioners' standard table for purposes of Sections 7702 and 7702A. Our clients are also pleased that the article recognizes that even under the 2001 CSO, reasonable mortality charges may exist, where justifiable, at rates higher than otherwise provided for under the 2001 CSO.

We appreciate this opportunity to emphasize the benefits the Model Regulation will provide the preneed insurance industry. Thank you for permitting us to respond to this upcoming *Taxing Times* article.

Very truly yours,

Anton L. Janik, Jr.
MITCHELL, WILLIAMS, SELIG,
GATES & WOODYARD, P.L.L.C.

SOCIETY OF ACTUARIES

475 N. Martingale Road
Suite 600
Schaumburg, Illinois 60173
Web: www.soa.org